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OPERATION OF THE BANKRUPTCY SYSTEM AND STATUS REPORT FROM THE NATIONAL BANKRUPTCY REVIEW COMMISSION

WEDNESDAY, APRIL 16, 1997
House of Representatives,
Subcommittee on Commercial and
Administrative Law,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2237, Rayburn House Office Building, Hon. George W. Gekas (chairman of the subcommittee) presiding.

Present: Representatives George W. Gekas, Bob Inglis, Ed Bryant, Jerrold Nadler, Sheila Jackson Lee, William D. Delahunt, and Martin T. Meehan.

Also present: Representative John Conyers, Jr.

Staff present: Charles E. Kern II, counsel; Audray Clement, staff assistant; and Perry Apelbaum, minority chief counsel.

OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. **GEKAS.** The hour of 10 o'clock having arrived, this hearing of the Subcommittee on Commercial and Administrative Law of the full Judiciary Committee will come to order, and pursuant to the chairman's own edict, we will recess until a quorum appears. But this has permitted me to conduct my customary opening on time and then wait around for the Members to appear. So let's do that together.

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For the information of the audience, a hearing quorum can be made up of one Member besides the Chair; and then a working quorum, five Members; and then a voting quorum, six Members. So when we next meet with the bankruptcy experts after October, we will need more people than the ones that will appear here today, I am sure.

[Brief recess.]

Mr. **GEKAS.** The hearing will come to order. Even though we do require another Member for a hearing quorum, we have consulted with the counsel for the minority, who has no objections to register at this juncture, therefore out of courtesy to the witnesses who have taken their time and expended energy to be here in the first place, we will proceed with the hearing.

We will make the transcripts available to anyone who wishes to review them, and if there be any future objection on the conduct of this hearing from any Member, we may have to reconvene and have someone read the transcripts at the hearing. Therefore, we will officially begin.

Naturally, the purpose of this hearing is to give us a preliminary view of what we expect to be a robust report in October from the National Bankruptcy Review Commission. And as we await the recommendations in that document, there are related issues that arise on a daily basis for members of this subcommittee, and, indeed, for most Members of Congress.

From what we hear today, we should have an indication of some of the issues with which we will have to grapple after October, and we may be in a position to consult immediately with the members of the Commission and other experts to see what we can do in the meantime to prepare legislatively for that final report.

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In the meantime, we do have a wide range of people before us who are very knowledgeable in the subject matter, and we will proceed to hear from them today. And we know that the Members of the committee will take an increasing interest in the issue as we proceed towards the balance of this year.

[The opening statement of Mr. Gekas follows:]

OPENING STATEMENT OF HON. GEORGE W. GEKAS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA, AND CHAIRMAN, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

As is well known to everyone here present, in October this Subcommittee will receive the report and recommendations of the National Bankruptcy Review Commission. For nearly two years, the Commission's work has held the interest of virtually every segment of the bankruptcy community. I cannot stress too strongly that He release of the Commission's report will be a major event. Inasmuch as bankruptcy is a central and very complex part of our Subcommittee's jurisdiction, we are very pleased that the Chairman of the Review Commission is here this morning to describe its progress and the issues that are being addressed.

I anticipate that soon after the Commission report is issued that a substantial amount of remedial legislation will be introduced and referred to this Subcommittee. Our members will then commence the lengthy and sometimes difficult process of choosing among alternatives and enacting the best proposals into new bankruptcy law.

The road to bankruptcy reform within this Subcommittee will demand the best efforts of each of our members. Our members will also inevitably be looked to in full Committee and on the floor for their expertise in this subject matter. What we intend to do here this morning, therefore, is to contribute to our members' understanding of the bankruptcy process, so that we will all be better equipped to do our difficult job later on.

In addition to Chairman Williamson of the NBRC, thee very distinguished private practitioners and a former President of the National Conference of Bankruptcy Judges are here to share with us their experience and insight into the bankruptcy process and some of the important issues which are certain to preoccupy us as a Subcommittee later on. I am particularly gratified that so many of our members are in attendance, and I now yield to our ranking minority member, Mr. Nadler, for any remarks he may choose to make.

Mr. **GEKAS.** We now note the presence of a quorum for the purposes of a hearing, the gentleman from Massachusetts now being present, we will proceed with the first panel of witnesses.

Does the gentleman wish to make any opening statement?

Mr. **DELAHUNT.** No, Mr. Chairman, I just came to save the hearing. That is the purpose of my arrival, and also to be educated.

Mr. **GEKAS.** And we now acknowledge the presence of the gentleman from Tennessee, Mr. Bryant.

On our first panel this morning we have the following individuals, who are already seated at the table. Brady Williamson, a partner in the law firm of LaFollette Sinykin, in Madison, WI, who also teaches bankruptcy and constitutional law at the University of Wisconsin Law School. He was a member of the Law Review at Georgetown University Law School, from which he graduated in 1975. In March 1996, soon after the death of our former colleague Mike Synar, he was appointed as Chairman of the National Bankruptcy Review Commission.

With him is Steven H. Case, a partner in the Washington office of Davis, Polk & Wardwell, who has practiced bankruptcy law since 1970. He teaches as an adjunct professor of law at Georgetown and received his undergraduate and law degrees from Columbia, where he was editor-in-chief of the Columbia Journal of Law and Social Problems.

As recently as July 1995, he was very helpful to this subcommittee by appearing as a witness on behalf of the National Bankruptcy Conference at one of our previous hearings.

With the first two witnesses is Leonard Rosen, a partner in the law firm of Wachtell, Lipton, Rosen & Katz. He was also an editor of the New York University Law Review in his student days, and has been an adjunct professor of law at that institution since 1979. He has been chairman of the Committee on Bankruptcy and Corporate Reorganization in the New York City Bar Association and served as Chairman of the National Bankruptcy Conference for 8 years, from 1984 to 1992.

We will begin the testimony with Mr. Williamson, and advise all the witnesses that their written statements will be admitted into the record without objection. We would appreciate a 5-minute presentation.
Mr. **GEKAS.** Mr. Williamson.

STATEMENT OF BRADY C. WILLIAMSON, CHAIRMAN, NATIONAL BANKRUPTCY REVIEW COMMISSION

Mr. **WILLIAMSON.** Thank you very much, Mr. Chairman. We will try to do even better than your 5-minute limit to leave plenty of time for questions and dialog with the members of the subcommittee.

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The American bankruptcy system is grounded ultimately not in the statutes passed by the Congress, but in the Constitution. The Constitution in article I, section 8, has given the exclusive power to the Congress to provide for quote, "uniform laws on the subject of bankruptcy throughout the United States."

The Commission, as the chairman and members of the subcommittee know, has been engaged in a series of hearings, and meetings in Washington and across the country, at the request of Congress, to take testimony, and hear witnesses talk about their concerns with the American bankruptcy most often system. One of the concerns that we have heard expressed is that for certain aspects of the American bankruptcy system, the law is neither uniform nor entirely Federal.

Two examples: First, the subject of homestead exemptions is a matter that potentially affects every homeowner in this country who faces financial difficulty. Homestead exemptions vary greatly across this country. In the chairman's State of Pennsylvania, there is no State homestead exemption. In the States of Texas and Florida and a few others, there are unlimited homestead exemptions. There is always a Federal exemption available, for States that have chosen not to opt out of the Federal system. But homestead exemptions, which are one of the central elements of the bankruptcy system, vary greatly from State to State. This is an area that we think the Congress will want to focus on and an area where the Commission will have a recommendation for the Congress when it files its report in October.

Another area where we have heard expressions of concern about lack of uniformity is in consumer bankruptcy where the two principal vehicles, as the Members know, are chapter 7 and chapter 13. In Congressman Bryant's State, for example, chapter 13 is the method used by three out of every four consumer debtors.

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In Congressman Delahunt's State, the figures are the reverse so that chapter 7 is the vehicle of choice for most consumer bankruptcies. The national trend, of course, is closer to the figures in Massachusetts than in Tennessee.

I look forward to hearing the testimony later this morning from Judge Paine, who, of course, holds a seat on the Bankruptcy Court in Tennessee. I think we have a great deal to learn from the success story there in the use of chapter 13. But, again, it is not a uniform process.

The concerns we have heard expressed over the last year take on a sharper focus because of economic developments in this country in the last 18 months. As I am sure everyone on the panel and everyone in this room knows, consumer bankruptcies rose to 1.2 million in 1996, and that was an increase of 27 percent over the previous year. We have provided each member of the subcommittee with a separate folder that shows the increase, both nationally and in each Member's district.

No district has been immune. There have been increases in literally every judicial district in this country. We have brought two charts, which the Members may want to look at during the hearing, that show the dramatic increase in consumer bankruptcies over the last 18 months as well as the bankruptcy filing trend over the last 16 years.

These charts are familiar to those of us on the Commission and familiar to those who have studied this area, and they really speak for themselves. The trends are dramatic and specific.

We have heard a great deal of differing testimony at the Commission on the causes for this trend. And I think we can talk about that in the dialog that I hope will ensue after my testimony and the testimony of my colleagues is completed.

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I also want to compliment the chairman on the timeliness of this hearing, because the focus on consumer bankruptcy is reflected not only in the statistical data, but in the news media's coverage of the changes in the American economy and American law. For example, the U.S. Supreme Court today is hearing a case called *In re Rash,* that will decide how assets and collateral are valued in bankruptcy. It is a very important case and undoubtedly there will be a very important decision before the end of June of this year.

CNN this morning carried a story about the solicitation of college students by those issuing credit. Every day, though, in every district in this country, the number of consumer bankruptcy filings is on the increase.

The chairman referred in his opening remarks to what he hoped would be the "robust" report that the Congress will receive from the Commission on October 20. I hope it will be robust. I think it will be robust and controversial. Mr. Chairman, because it is my view that Congress did not appoint a Commission to avoid issues, but rather to take on the issues; to, in effect, invite controversy and debate. That is precisely what we have done.

Over the last year the Commission has held 12 hearings all across the country. I leave this afternoon for Seattle where we will have our 13th hearing, tomorrow and the day after. We have met across the country, and have had regional hearings in Des Moines, IA, and Akron, OH. More regional hearings are scheduled in the next 3 months.

All together we have had more than 1,500 submissions to the Commission in the form of written proposals, letters, e-mail, and other forms of communication. The Commission process, which has involved these national and regional hearings, has actively involved almost 400 people in testimony and participation.

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At every hearing we have an open forum at which, without invitation or advance notice, anyone can testify. Indeed the Commission's single biggest achievement to date has been the creation and maintenance of a national dialogue on the bankruptcy system.

The Congress was either very lucky or very farsighted when in 1994 it created this Commission, set nine people as members, bipartisan, appointed by the President, the Chief Justice of the United States, and the leadership of both houses of Congress to review what is essentially the last 100 years of American law.

Mr. **GEKAS.** We will note that you accuse the Congress of being foresighted.

Mr. **WILLIAMSON.** But I also give you room to be lucky, Mr. Chairman.

[The prepared statement of Mr. Williamson follows:]

PREPARED STATEMENT OF BRADY C. WILLIAMSON, CHAIRMAN, NATIONAL BANKRUPTCY REVIEW COMMISSION

Good morning. I am the Chairman of the National Bankruptcy Review Commission, which was established by the 103d Congress in the Bankruptcy Reform Act of 1994, with nine members appointed by the President, the Chief Justice and the leadership of both parties in both houses of Congress. The Commission was created to investigate and study issues relating to the Bankruptcy Code; solicit divergent views on the operation of the bankruptcy system; evaluate the advisability of proposals with respect to such issues; and, prepare a report to the President, the Congress and the Chief Justice not later than two years after the date of the first meeting. This report will be filed on time on October 20, 1997, and it will contain a detailed statement of the Commission's findings and conclusions together with recommendations for legislative or administrative action.

Over the past year, the Commission has been conducting a series of public meetings and hearings on a monthly basis, and we have submitted three progress reports to the House and Senate Judiciary Committees through this Subcommittee and through the Subcommittee on Administrative Oversight and the Courts in the Senate. We have taken very seriously the direction of the Congress in its enabling legislation "to solicit divergent views." The Commission already has given its initial approval to more than a dozen substantive recommendations. Yet its single most significant accomplishment to date has been the creation of a national dialogue on the American bankruptcy system at a particularly critical time.

MEETINGS AND PUBLIC OUTREACH

Since its inception, the Commission has held 12 full-Commission meetings and two regional hearings. Later today, we leave for Seattle where we will hold the 13th full-Commission meeting. To date, the Commission has heard from more than 1500 people and organizations in written and oral comments, and it continuously elicits additional comment through its outreach efforts including mailings and its website, which has been accessed by several hundred people in the last two months. Since I became chairman, after the untimely death of former Congressman Mike Synar early last year, every meeting--without exception--has had time set aside for at least one open forum at which members of the public testify. More than 190 witnesses have testified at Commission hearings and open forum sessions, and more than 390 people from all segments of the bankruptcy community have been directly involved in the Commission's working groups and round table discussions. All of the Commissioners, as well as its advisors, are extremely accessible to both the public and every segment of the bankruptcy community.

The Commission has established a truly national dialogue on bankruptcy, meeting in Louisiana, Texas, New Mexico, California--and in Seattle, beginning tomorrow--all in addition to regular meetings in Washington, D.C. Continuing the practice it began in Ohio in December, the Commission also is holding a series of regional hearings, each involving several Commissioners: in Iowa two weeks ago, New York next month, and Alabama in June. The Commission continuously expands its database that now makes over 1000 written comments and recommendations accessible to Commissioners and Commission staff as well as to any member of the public. The Commission has met eight times in Washington, D.C., most recently in locations provided by the U.S. House of Representatives (December), the Administrative Office of the U.S. Courts and the Federal Judicial Center (January), and the U.S. Senate (February).

UPDATE ON CONSUMER BANKRUPTCY

The most challenging and, perhaps, the most important subject facing the Commission today is consumer bankruptcy. Consumer bankruptcy filings continue to rise across the country. According to information released on March 18 by the Administrative Office of the U.S. Courts, the number of bankruptcy petitions filed in 1996 was more than 27 percent higher than in 1995. Approximately one in every one hundred American families will file for bankruptcy during 1997. A number of factors contribute to this rising tide of bankruptcies, and the assessment of this trend is one of the Commission's priorities. To this end, it has held several hearings and discussions, most recently in January when economists and academics presented the latest research on the correlation between consumer debt and bankruptcy and the statistical profile of families that file for bankruptcy.

Federal Exemptions

The Commission already has approved an initial recommendation on federal exemptions after several hearings and discussions. The exemption proposal defines the assets that will be available for distribution to creditors. Under this proposal, states would retain flexibility within a specified range in determining bankruptcy homestead exemptions, but the Bankruptcy Code no longer would authorize states or debtors to "opt out" of the federal exemption laws. The uniform federal exemption proposal is designed to enhance the integrity and fairness of the system and to address the widely varied exemptions in the different states.

A few states, like the Chairman's home state of Pennsylvania, have no homestead exemption. For the states with exemptions, the range is very wide: from a $5000 homestead exemption in Congressman Inglis' home state of South Carolina and Congressman Chabot's home state of Ohio to an almost unlimited exemption in Florida and in Texas, which is the home state of both Congresswoman Jackson Lee and Congressman Smith. How many debtors actually benefit from an unlimited homestead exemption? In practice, probably not many since the exemption protects only the equity in one's home, which for most debtors in bankruptcy is not very high, but the disparity in exemptions leads to a perception of unfairness. The Commission continues to develop the details of this proposal, which will be presented for further Commission approval tomorrow. So far, the Commission has received constructive and favorable responses to this recommendation.

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Consumer Financial Education

There remains near unanimity on the need to expand the availability of consumer financial education. Most concur that implementing financial education through the bankruptcy system--which might include basic informational sessions on credit, budgeting, and debtors' and creditors' rights--merits serious consideration as an additional way to help prevent future financial failure. In December, the Commission devoted a significant portion of its Consumer Bankruptcy Working Group session to this topic. Since then, a variety of individuals and representatives--consumer credit counselors, legal scholars, creditors, judges, trustees, and credit reporting agency representatives--have agreed to help develop a pilot system for voluntary educational programs for debtors in both Chapter 7 and Chapter 13.

Tentative Consumer Bankruptcy Proposal: Specific Recommendations for Changes to Chapter 7 and Chapter 13

In light of the rising number of people, both debtors and creditors, involved in the consumer bankruptcy process, the Commission's continuing focus on the consumer bankruptcy system is especially important. Throughout the last year, the Commission has been conducting a careful and comprehensive review of the consumer bankruptcy system. The Commission's Consumer Bankruptcy Working Group has now put together a framework to amend Chapters 7 and 13. Lee approach would not change the fundamental architecture of the consumer bankruptcy system. Rather, it would build upon the present system to try to make it fairer and more uniform while providing reasonable incentives for more debtors to choose to repay more debt in Chapter 13. These proposals have been circulated to the broadest possible audience, including the Commission's consumer mailing list of more than 400 people and groups, and the Commission will hear testimony both on the approach and its details at its April and May meetings.

THE CONTINUING DECISION-MAKING PROCESS: ADDITIONAL RECOMMENDATIONS

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The Commission's initial decision-making has progressed steadily over the past year. The Commission has developed additional recommendations to enhance and simplify jurisdiction and procedure and, generally, to improve the bankruptcy system. While always subject to reconsideration, the proposals now tentatively slated for inclusion in the Commission's final report include:

Venue for Chapter 11 Cases: The Commission has decided to propose the modification of an "affiliate rule" to prohibit a corporate bankruptcy filing in an inappropriate venue unless that debtor's corporate parent had a bankruptcy case pending in that forum. This follows the Commission's decision in December to recommend elimination of the place of incorporation venue option for corporate debtors. Elimination of the state of incorporation as a sole factor for proper venue would focus venue choices on those places with a strong connection to the debtor's business: either the principal place of business, for example, or the location of most of the debtor's assets.

Appellate Structure: The Commission has voted to recommend elimination of the first layer of review from the current appellate system that now provides for two levels of appeal from bankruptcy court decisions. Appeals from final bankruptcy court orders would go directly to the U.S. Court of Appeals, rather than, as now required, to either the federal district court or the Bankruptcy Appellate Panel that exists in some circuits, and only then to the court of appeals.

Absolute Priority and Claims Classification: The Commission has voted on an initial recommendation to clarify 1122 of title 11 to provide more flexibility in the classification and treatment of unsecured claims based on sound business decisions in a plan of reorganization. The Commission also has approved an initial recommendation to amend 1121 and 1129(b) of the Code to maximize the value of a reorganizing business by permitting creditors to propose competing plans of reorganization when a debtor's non-consensual plan of reorganization includes new capital contributions from prepetition equity holders or owners. Such an amendment would help solve a problem that has plagued the courts by clarifying that equity holders and owners can be the source of a capital infusion, while ensuring that they pay a market price for the company.

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Article III Status and Transition: The Commission has agreed to recommend that bankruptcy courts become Article III courts. To facilitate this suggested change, the Commission unanimously endorsed a comprehensive and detailed procedure for a gradual transition from the current Article I structure. Making bankruptcy judges Article III judges would eliminate many of the jurisdictional questions that have haunted the bankruptcy system since the Supreme Court's *Marathon Pipeline* decision in 1982.

Review of Creditors' Committee Appointments: Another area of agreement is an amendment to 1102 of the Code to ensure full and fair representation of creditors' interests by providing that parties can seek judicial review of creditors' committee appointments made by U.S. Trustees. This would ensure that creditors participating in the bankruptcy process have adequate representation.

Disinterestedness: A suggested modification to 327(a) of the Code has been approved to clarify that professionals retained by a Chapter 11 debtor must disclose all potential conflicts and be free of interests that are materially adverse to the bankruptcy estate but need not be "disinterested." This modification creates a clearer standard for debtors, creditors, and professionals.

Chapter 12 special tax provisions: The repeal of special tax provisions of 1231 has been recommended as well.

OTHER PENDING MATTERS

As it continues its study of a broad range of bankruptcy issues, the Commission will address specific proposals in other areas at its meetings in April and May:

Mass Tort Liabilities: The Commission is developing a set of proposals that, taken collectively, would help create a fair and equitable structure for the treatment of a wider range of mass tort liabilities, including future claims. Under the 1994 Act, the "asbestos amendments" reflected a general recognition that extensive tort liabilities threaten the continuation of otherwise viable business enterprises and that there is a corresponding need to provide a fair and cost-efficient treatment of mass tort claims that does not destroy a business, costing employees their jobs. Like the 1994 amendments, the Commission's tentatively proposed structure, still under consideration, would provide compensation for victims while protecting both the jobs of working men and women and the productivity of the enterprise.

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Expedited Procedures for Certain Small Business Chapter 11 Cases: The Commission has sought to identify persistent problems in some small business Chapter 11 cases. The Commissioners have been considering the relative benefits of additional tools to strengthen and enhance those provided for in the 1994 amendments, especially when active creditor involvement is lacking in a case. The Commission's tentative proposal, not yet approved, would endorse the continued availability of Chapter 11 to small business debtors. In addition, however, Chapter 11 would be modified to simplify the process--by reducing plan and disclosure statement requirements and improving its efficiency, by enhancing the debtor's duties to disclose financial information and comply with Chapter 11 obligations, and by increasing the supervisory role of the U.S. Trustee. In its deliberations on this issue, the Commission has included a variety of interested parties, including judges, attorneys, U.S. Trustees, and Bankruptcy Administrators.

Partnership Bankruptcies: The bankruptcy filing of a partnership or partner gives rise to a unique set of issues not encountered in other bankruptcy cases. These issues have been the subject of intensive study by several national organizations that now are sharing their results with the Commission to assist it in its deliberations. The Commission anticipates taking a position on these matters later this spring.

Contracts and Leases under Section 365 of the Bankruptcy Code: Contracts and leases often are both critical assets and obligations in business and consumer bankruptcies, and 365 of the Bankruptcy Code provides the framework for their treatment. Both the legislative history and case law reflect the widely-held view that this provision would benefit from a comprehensive approach to reform. The suggestions being developed by the Commission, with wide support from the bankruptcy community, would clarify the rights and remedies of debtors and non-debtor parties to contracts and leases, consistent with the conceptual direction of Congress' series of amendments to 365 since its enactment in 1978.

Taxes and Bankruptcy: The intersection of bankruptcy and tax has been a subject of continuing discussion among the Commissioners and in the Commission's Government Working Group. To analyze these issues, the Commission has heard from a variety of witnesses throughout the last year, and it has been working closely with representatives of the Department of the Treasury, the Department of Justice, a variety of state and local taxing authorities, and members of the private sector. The Commission now will have the benefit as well of an advisory committee that represents a wide range of public and private interests. This group is reviewing the voluminous list of tax issues submitted to the Commission by interested parties and is scheduled to report its findings later this spring.

Municipal and Family Farm Bankruptcies: The Commission also has addressed Chapters 9 and 12 of the Bankruptcy Code, which establish special procedures, respectively, for the adjustment of debts of a municipality and the special needs of the family farmer. At the February meeting, the Government Working Group considered several specific issues in need of clarification in municipal bankruptcy. It will continue this dialogue at the Commission's meeting in April. The Chapter 12 discussion is focusing on, among other things, extension of the law beyond its current 1998 sunset date.

COMMISSION EVENTS

The full-Commission meetings, each spanning at least two days, over the last four months have been of particular interest. The meeting on December 17 and 18 at the Rayburn House Office Building featured an all-morning hearing on issues facing the consumer credit industry, with four panels of witnesses presented by the credit industry. In addition, the Commission held plenary sessions to continue its focused work on mass tort liabilities and on contracts and leases in bankruptcy.

When the Commission reconvened on January 22 and 23 in Washington, D.C. at the Administrative Office of the U.S. Courts and the Federal Judicial Center, economists and scholars reported on the latest consumer bankruptcy trends and data. At this meeting, the Commission also held a round table discussion on small business bankruptcies and the procedures that might expedite the process in languishing cases. In addition, the Commission began its review of issues related to the U.S. Trustee Program.

Continuing its monthly meeting schedule, the Commission met again on February 20 and 21, this time in the Dirksen Senate Office Building, and featured an open forum on the U.S. Trustee Program. This meeting also marked the inception of the Commission's consideration of municipal bankruptcies and Chapter 12 family farm bankruptcies. In addition, the Commission received an update on the progress of an international task force on transnational insolvency. The tax advisory committee began its analysis of bankruptcy tax issues during this month as well.

On March 3, in connection with the Commission's interest in improved bankruptcy data collection and dissemination, Commissioner John Gose participated in the Conference on Future Bankruptcy Data Needs, a symposium sponsored by the Administrative Office of the U.S. Courts that involved a variety of government agencies, private organizations, and academics. Through Commissioner Gose, in consultation with Professor Lynn LoPucki of Cornell Law School, the Commission will work on this issue with the Administrative Office of the U.S. Courts, the Executive Office for U.S. Trustees, and other interested public and private groups.

The full Commission meets tomorrow and the next day in Seattle. At this meeting, the Commission will proceed with its work on consumer, small business, and farm and municipal bankruptcies in addition to a variety of other matters.

Consistent with its practice, the Commission will hear extended testimony on the consumer bankruptcy system, with particular focus on its recently disseminated preliminary proposals, and will feature several open forums. Thereafter, a three-day meeting in Washington, D.C. is planned for May 14, 15, and 16. The Commission will continue to provide Congressional staff with its tentative proposals and substantive memoranda, and we will submit its fourth and final quarterly progress report to the Congress in July, with the final report three months later.

Thank you for inviting me to participate in this briefing today. I am happy to answer any questions you may have.

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Mr. **GEKAS.** We defer to the second witness. Mr. Case.

STATEMENT OF STEPHEN H. CASE, ESQ., DAVIS, POLK & WARDWELL

Mr. **CASE.** Thank you, Mr. Chairman.

I would like to focus, please, on four points. One is the astonishing caseload of bankruptcy judges today. Second, everyone knows that debtors *gain* debt forgiveness in bankruptcy. I want to address briefly what some debtors lose in chapter 7. Third, I will tell you a short war story to illustrate how difficult the issues presented about consumer bankruptcy are. And fourth, I will have a couple of sentences about the difficulty of your job in this situation.

One, the caseload: There are approximately 325 bankruptcy judges. In fiscal 1996, there were 1,112,000 bankruptcy filings. That is 3,420 cases per judge. At 2,000 working hours per judge, that means that each judge on average has only 35 minutes per case per year. Things are worse in busy districts. For instance, in Maryland this year they are expecting 7,000 new cases per judge. That averages 18 minutes per judge per case per year.

I believe that the members of the bankruptcy judiciary are coping brilliantly with this amazing level of demand. Nevertheless, I submit that the questions for Members of Congress are obvious. How do the judges do it? How can we expect them to do it? When they are so loaded down, do they have time to deliberate and conduct trials on difficult, close matters?

Point 2: What do debtors lose in bankruptcy? In my experience, based on many conversations, I find a lot of people don't know that the debtor loses something in a chapter 7 as well as getting out of debt. For an example that I mentioned once before here, consider the late John Connolly. As Governor of Texas, he caught a bullet in the Kennedy assassination. As a Democrat, he was Secretary of the Navy. As a Republican, he was Secretary of the Treasury. As a real estate investor, he ended up in chapter 7. The trustee in bankruptcy auctioned off all of his assets except what was exempt under Texas law. He and Mrs. Connolly were lucky. Friends bought the family keepsakes at the auction and returned them to the family.

Take another example, my best friend from grade school. He owned a five-worker machine shop that got into trouble. Chapter 11 didn't work. He, too, became a chapter 7 debtor. The trustee auctioned his business, his house and most of his belongings except what was exempt under local law. There was no group of loyal friends to buy things at auction. It was dreadful. The strain broke up his marriage.

Some cases, new ones, present the courts and the policymakers with very difficult questions. For instance, at the National Bankruptcy Review Commission hearing in Des Moines, the judge from a Midwestern State told of a case just filed in his court. A 66-year-old man who lived solely on $500 a month from driving a taxi, plus his Social Security, had recently filed. From consumer lenders, this debtor had borrowed $85,000 in the 4 months before bankruptcy, all of which he lost at casinos.

Think of the difficult questions. Who was at fault in this situation? Was it the debtor for reckless borrowing and spending? Was it lenders for reckless lending? Is this filing an abuse of the bankruptcy system? Should the debt be forgiven? If the debts are not forgiven, would the individual ever be able to pay it off? If he is discharged from debt, will Federal law be unwisely rewarding reckless behavior by a consumer debtor?

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So far I have addressed three questions: One, the judges are overworked; two, many debtors sustain significant personal losses in order to gain debt forgiveness in bankruptcy; three, I think it is fair to say that creditor and debtor representatives agree that Federal law should provide an efficient system to deliver finality and a fresh start. They disagree sharply over which debtors should receive precisely what kind of relief.

The Commission will report in October. As the members of this great committee consider the issues, I ask you not to forget the root of the problem: human beings in frightening personal financial trouble. God forbid, it could be you; it could be me. They all need a solution. They all need to get it under control. Sooner or later, they need to get it behind them. The American public needs an efficient, fair and well-administered bankruptcy system.

One sentence to conclude. For decades this subcommittee has consistently fulfilled a brilliant tradition of careful deliberation and wise decisionmaking, particularly in bankruptcy matters. In the months to come I will watch with great interest to see how the Members continue that tradition and undertake to resolve the difficult issues that Mr. Williamson's Commission will present. Thank you.

[The prepared statement of Mr. Case follows:]

PREPARED STATEMENT OF STEPHEN H. CASE, ESQ., DAVIS, POLK & Wardwell

I am Stephen Case. I am partner of Davis, Polk & Wardwell. I am a Senior Advisor to the National Bankruptcy Review Commission. However, I appear today solely as a practitioner. I do not speak for the NBRC.

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I've been handling financial-distress, business cases since 1970. As Adjunct Professor of Law at Georgetown, I teach consumer-bankruptcy law. Occasionally, I represent an individual suffering financial distress.

May I focus on four points? One is the astonishing case load of bankruptcy judges. Second, everyone knows that debtors *gain* debt forgiveness in bankruptcy. I will address what consumers lose in chapter 7. Third, I will tell a "war story" to illustrate how hard it sometimes is to decide which debtors should get relief. Fourth, I address the difficulty of the public-policy choices which face the members of this great Committee.

1. The Caseload. There are 325 bankruptcy judges. In fiscal 1996, there were 1,112,000 bankruptcy filings, or 3420 cases per judge. At 2,000 working hours per year, each judge, on average, has only *thirty-five minutes per case per year!* Things are worse in busy districts. For instance, Maryland expects 7,000 new cases per judge in 1997. This averages approximately *eighteen minutes per case!*

Our judges cope brilliantly with this amazing level of demand.

Nevertheless, the questions are obvious. How do the judges do it? How can we expect them do it? When so loaded down, how can they conduct trials?

2. What Debtors Lose in Bankruptcy. Everyone knows that debtors *gain* debt forgiveness in personal bankruptcy. In my experience, however, based on many conversations, I find that many people do not know what some debtors *lose* in the process.

An example: please consider the late John Connolly. As Texas' Governor, he caught a bullet when Kennedy was killed. As a Democrat, he was Secretary of the Navy. As a Republican, he was Secretary of the Treasury. Later, as a real estate investor, he filed chapter 7. The trustee in bankruptcy auctioned all his assets, except for Texas-law exemptions. He and Mrs. Connolly were lucky. Friends bought the keepsakes and returned them as gifts.

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Another example: my best friend from grade school. He owned a five-worker machine shop. It got into trouble. Chapter 11 didn't work. He, too, became a chapter 7 debtor. The trustee in bankruptcy auctioned his business, his house and most of his belongings, except, again, for exemptions. No large group of loyal friends bought everything at his auction. The strain destroyed his marriage.

3. Hard Questions--An Example. Some cases present hard questions.

For example, a bankruptcy judge told an NBRC hewing of a 66 year old man who lived solely on social security plus $500 a month from driving a taxi. From consumer lenders, he borrowed $85,000 in the four months before bankruptcy. He lost it all in casinos. These facts present difficult questions. Who was "at fault"? Was it the debtor for reckless borrowing and spending? Was it lenders for reckless lending? Is this an abuse of the bankruptcy system? Should the debt be forgiven? If the debts are not forgiven, will he ever be able to pay? If he is discharged, will this unwisely reward reckless behavior?

So far, I have addressed three problems.

One. The judges are overworked.

Two. Many debtors lose assets in order to gain debt forgiveness.

Three. Creditors and debtors agree that federal law should provide an efficient system to deliver finality and fresh start. They disagree about who deserves precisely what type of relief.

Fourth, the NBRC will report in October. In considering the issues, I ask you not to forget the root of the problem: human beings in frightening financial trouble. (It could be you. It could be me). They all need a solution they all need to get it under control. Sooner or later, they need to get it behind them. The American public needs an efficient, fair, well-administered bankruptcy system to address these problems.

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For decades, this Committee has consistently fulfilled a brilliant tradition of careful deliberation and wise decision making, particularly in bankruptcy matters. In the months to come, I will watch with interest to see how the members resolve the issues which the NBRC will present in October.

Mr. **GEKAS.** We turn now to Mr. Rosen.

STATEMENT OF LEONARD M. ROSEN, ESQ., WACHTELL, LIPTON, ROSEN & KATZ

Mr. **ROSEN.** I am appearing as an individual and not on behalf of any organization. I have spent most of my career working on workouts and reorganizations of businesses and corporations.

The American system of dealing with a failed business is in part similar and in part dissimilar from the systems in other countries, and I think there is something to be learned from it. In terms of businesses that need to be liquidated and that are hopelessly insolvent, the systems are the same here and elsewhere. You basically get a trustee or receiver who liquidates the business, and then there is a distribution to creditors in the order of priority.

With respect to reorganization, the system is different. The American system is basically unique and different from systems in other countries, including sister countries such as England and Canada. In the American system there has always been a way for companies to try to reorganize and try to rehabilitate. They get time. In most other countries there has not been that system. There has been a liquidation process rather than a reorganization process. And in recent years other countries have, in fact, been looking to the American system, which is embodied in chapter 11, adopting pieces of it to permit rehabilitation, because the sense that one gets is that it is better to give a business a chance to reorganize. People have looked at the American system as one which has worked somewhat better than systems that are biased towards liquidation.

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However, here, chapter 11, which is the vehicle for reorganization, has been under attack. Some are saying it takes too long. Some are saying it is too expensive. Some are saying it doesn't work for small businesses. And some academics have even said chapter 11 should be abolished and we should go to some system of relatively quick liquidation.

As one who has practiced in the area, my experience tells me that chapter 11 continues to be the way to go, and that the structure created in the 1978 legislation is a proper structure, and that what needs to be done is that chapter 11 has to be looked at from the point of view of trying to meet the problems that have emerged in the last 20 years of its operation.

Those problems include questions as to the jurisdiction of the Bankruptcy Court. The Bankruptcy Court is not an article III court. It has limited jurisdiction. A great deal of time is spent figuring out where controversies should be resolved, the Bankruptcy Court or the district court.

The appeals system is archaic. There are two appeals, first to the district court, then to the court of appeals. Why should there be two appeals? Again, it is a waste of time and money.

The system doesn't seem to accommodate small businesses. Many of them go into chapter 11. They probably don't belong there. They probably should be liquidated. Others that do belong there find that it is expensive and takes too long.

There is a problem with mass tort cases. Cases that resulted from asbestos liabilities and the Dalkon Shield have wound up in the Bankruptcy Court. The statute was never designed to deal with mass tort and future claim cases. The statute needs tinkering in that respect.

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These problems and some others are all being addressed by the Commission. They have all been voiced by various people appearing before the Commission. So my own feeling is that what the act needs with respect to chapter 11 and reorganization is a look at problems that have arisen that need to be accommodated by the statute.

But on the other hand, the basic structure I think is sound. I think the idea of giving a business a reasonable chance to rehabilitate is the correct approach; that the approach used elsewhere in the world in looking to liquidation first is unsatisfactory, and that the rest of the world seems to be going in our direction. So we should not lose heart about the validity of chapter 11. We should rather attempt to make it a little bit better and go forward in the future. Thank you.

Mr. **GEKAS.** We thank you, Mr. Rosen.

[The prepared statement of Mr. Rosen follows:]

PREPARED STATEMENT OF LEONARD M. ROSEN, ESQ., WACHTELL, LIPTON, ROSEN & Katz

I am counsel to the law firm of Wachtell, Lipton, Rosen & Katz in New York, N.Y. and have been an active practitioner in the bankruptcy and reorganization area for over 25 years. I am a member of the National Bankruptcy Conference and was the Chairman of that conference from 1984 to 1992. I am an Adjunct Professor of Law at New York University School of Law.

The business bankruptcy system in the United States is in part similar and in part different from the systems in other countries. In terms of businesses that are to be liquidated, it is similar to the systems in most other countries which call for the appointment of a disinterested person to conduct a liquidation and distribution of the debtor's assets.

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In terms of businesses which seek to reorganize, the U.S. system is unique and different. It has long found ways to attempt to give the debtor a chance to rehabilitate rather than liquidate and, under the current Bankruptcy Code, it permits an honest debtor and management to maintain control of the business in a Chapter 11 reorganization case, subject to a variety of protections given to creditors and subject to oversight by a judge and the U.S. trustee.

Most other systems provide for a third person akin to a receiver or trustee to take charge of the business and at best provide a relatively short period of time in which to attempt to accomplish any rehabilitation of the business. Under the United States system, the appointment of a trustee to take charge of the business is relatively rare.

In fact, in recent years many foreign countries have adopted or sought to adopt aspects of the U.S. practice in an effort to temper the harshness of a predisposition towards liquidation. Systems which have traditionally given much power to secured creditors (e.g. England and Canada) have sought to counterbalance that power so as to permit debtors at least a quick opportunity to rehabilitate rather than liquidate.

Here in the United States, the focus has been on whether Chapter 11 has been working well with some academics questioning whether it should not be radically changed or eliminated. Questions have been raised as to whether reorganizing under Chapter 11 takes too long and is too expensive, as to the difficulty which small businesses have in utilizing Chapter 11, as to the effectiveness and role of the U.S. Trustee program, as to the impact of the limited jurisdiction of the bankruptcy court and as to the cumbersome nature of the appellate process in bankruptcy cases, to mention a few of the more significant issues which have engendered discussion and proposals.

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As a practitioner who has dealt with out-of-court restructurings and Chapter 11 cases for over 25 years, I believe that our system which favors reorganization over liquidation is the better idea and that the statutory structure created in 1978 should not be abandoned. What is needed and would be useful, however, are adjustments to those parts of the system that experience has demonstrated are in need of refinement or improvement. Over the past 20 years, Chapter 11 has been used to cope with and resolve enormous problems (some of which it was never designed to deal with)--the massive filings resulting from the leveraged buyout debacle of the 80's, the filings caused by mass tort and other future claim problems and filings requiring resolution of environmental problems and unfunded pension plan problems--and it has proven itself to be a flexible, useful tool which has found ways of dealing with these problems and has helped save jobs and businesses. However, it is by no means perfect--it can use study and careful revision--and I believe the National Bankruptcy Review Commission is, in fact, giving it that study and is seeking to come up with constructive suggestions for improvement.

Following are particularly significant areas that I believe need review and that are being studied by the Commission:

1. The difficulty in dealing with bankruptcies involving mass tort and other future claim problems under a statute that was not designed with such matters in mind.
2. The status of bankruptcy courts as non-Article III courts creating unnecessary litigation over the proper forum in which to deal with a particular problem.
3. The unnecessary time and expense involved in having two levels of appeal from bankruptcy court decisions.
4. The difficulty small businesses have in utilizing Chapter 11.
5. Seeking to reduce costs and length of time of Chapter 11 cases.
6. Readjusting the balance of power in the conduct of Chapter 11 cases among the debtor-in-possession, creditors and equity holders.

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7. Improving the U.S. Trustee system.
8. Clarifying rules for partners and partnerships.

Thank you for the opportunity to appear before you. I will be pleased to try to answer any questions you may have.

Mr. **GEKAS.** The Chair will request from the Members that they conduct themselves under the 5-minute rule, and we will begin by limiting the Chair to the first round of 5 minutes in pursuit of some of the questions and, we hope, some of the answers.

We acknowledge the presence now of the gentleman from New York Mr. Nadler, who is the ranking member on the Democratic side of this panel.

Mr. Williamson, is a lot of the statistical data that you presented here due to the burgeoning credit card system? And if so, is the Commission weighing in on that particular problem? You and I discussed some aspects of this when you visited me in my office several months ago, but I don't fully remember what you said, to tell you the truth.

Mr. **WILLIAMSON.** Mr. Chairman, whatever I said, it probably has changed by now.

Mr. **GEKAS.** Good, then I won't know the difference.

Mr. **WILLIAMSON.** First, Mr. Chairman, let me note that the statistical data that we have, and that is available to the public, comes to us from the Administrative Office of the U.S. Courts, which does a wonderful job of collecting and providing this data. And it is they who deserve the credit for compiling the data.

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The question that the Chair has asked substantively, of course, is one that the Commission has heard literally hours of testimony on. And based on that testimony, I think one can only conclude that there is not one clear answer. There is a school of thought, or line of advocacy, that contends that there are so many factors at work that it is simply too complex to identify any one or a few causes.

For example, divorce obviously plays a role in consumer bankruptcy, but so does downsizing, the status of health insurance, a catastrophic event, a car accident, or an illness. All of those play some role.

There is another school of thought, or school of advocacy, that believes that the correlations here are not very complex, that there is a direct correlation between the increasing amount of debt and the increasing number of bankruptcies. For those that espouse that point of view, the increase in consumer credit, specifically unsecured consumer credit, is, if not the single cause then a leading cause of the increase.

This may be a question to which there will never be a satisfactory or simple answer, but we clearly have to deal with the ramifications.

Mr. **GEKAS.** In this statistical data, is there an increase in credit card default or not?

Mr. **WILLIAMSON.** Based on the Wall Street Journal's reporting and the other material that has been presented to us, I think the answer is yes there is, and I know this is of concern to the banking industry.

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Mr. **GEKAS.** The factors that are mentioned, divorce, illness, downsizing, debt, et cetera, we have always had illness as a factor in all our dealings. Divorce may be on the upswing in the numbers, but any observer of the scene has to indicate to himself, if not to others, that credit card default is a major factor. The Commission is going to have to disabuse me of the hardcore thinking that I am indulging that that is not the case.

So we will go on to something else, but I just wanted to make that a facet of my personal request to the Commission to thoroughly address credit card default in the forthcoming report.

Mr. Case, in your presentation you seem to apologize for the debtor who loses assets and so forth. And I understand that sentiment, but is it not true that the possible loss of one's assets can or should act as a deterrent to not overindulge, to not make risky decisions, all that kind of psyche that we want to employ in a system that does employ sanctions?

Mr. **CASE.** Mr. Chairman, I quite agree. The purpose of the point was to try and focus on that dimension to create a counterpoint to a point of view that is often thought to exist, or expressed by others, that bankruptcy is a walk in the park, and you pay a lawyer a few hundred dollars and sign some papers, and you walk away from your debts, and it is a luxury event. It is a painful event, and I am not proposing that debtor loss of assets in chapter 7 be changed.

Mr. **GEKAS.** Thank you.

Mr. Rosen, in the mass tort situation to which you have referred, which is with us on a daily basis here in the Congress on many different fronts, Do you believe that the current system invites a mass tort situation to find itself in chapter 11; is that what you are saying?

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Mr. **ROSEN.** No, I don't believe that. I believe that companies having that problem do their best to stay out of bankruptcy and to resolve the problems out of bankruptcy. But when they are overwhelmed by the problem and can no longer cope, they then wind up in chapter 11, and chapter 11 isn't designed to deal with future claims.

In other words, the problem with the asbestos cases is that the person who is injured doesn't necessarily yet know he or she is injured, and the injury may not turn up for 20 years. How do you deal with the fact that the company is now in chapter 11, you have got to make provisions for creditors, and there are some creditors out there who don't even know that they are injured. The system in chapter 11 was never drafted to accommodate it. Courts have created remedies to try to protect the person who gets sick 20 years from now, and they have been pretty successful, but they have stretched the statute. So what the statute needs is the ability to have a little more flexibility to deal with the problem.

They have been dealing with it. They have been doing it through the use of injunctions, but basically there are questions as to the validity of those injunctions. And so the statute needs amendment so that when a company gets desperate enough to go into chapter 11, there is, in fact, an available remedy with the proper safeguards to make sure that not only current creditors are satisfied, but that future creditors who may not yet be identified are also satisfied, or that a reserve is put aside for them.

Mr. **GEKAS.** May I ask, Mr. Williamson, if that is being considered in the final report of the Commission?

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Mr. **WILLIAMSON.** Absolutely, Mr. Chairman.

Mr. **GEKAS.** Thank you.

Mr. **WILLIAMSON.** I might add one or two sentences. This notion of mass torts and future claims is one that simply wasn't even on the horizon when this Congress in 1978 last overhauled the bankruptcy laws. And it is one of those areas where we are, in effect, being asked as an advisory commission, and you will be asked as a legislative body, to start afresh and to look at a problem that simply didn't exist the last time you addressed the question.

Mr. **GEKAS.** The time of the Chair has expired. We will now recognize the gentleman from New York for a double-barreled entry into the record, the first to be his opening statement, if he wishes to make one, and we will begin the clock after he tells us that the opening statement has concluded, which I hope is soon.

Mr. **NADLER.** It will be. Thank you, Mr. Chairman.

First let me apologize for being late. I was in the middle of a debate in the Democratic Caucus. And in Congress we are expected to be in 2 places at the same time.

I thank the chairman for scheduling this hearing today. I think it is very useful that we take time to hear now from members of the Review Commission, from practitioners, judges and academics on the issues that we are going to have to consider after the Commission's report is issued in October. It is an essentially useful exercise now because so many members of the subcommittee and many Members of the Congress have been elected since we last made any revisions to the Bankruptcy Code, any revisions at all, even in 1994.

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The rise in consumer bankruptcies should be of concern to all of us. It certainly is fair to question whether the code encourages bankruptcies that might otherwise be avoided, but I hope we will also have the opportunity to consider some of the economic forces pushing too many private citizens into bankruptcy and the role of irresponsible lending on the part of some creditors that may have contributed to the current situation.

I believe the rise in bankruptcies also highlights the need--and this was alluded to in some of the testimony that we heard--or at least the problem that creates the need in some districts where there are no judges. I know this is an issue on which we have substantial bipartisan agreement, and I look forward to working with you, Mr. Chairman, to ensure timely passage of a bill in this Congress.

Finally, I would like to pay particular note and welcome Leonard Rosen of Wachtell, Lipton, Rosen & Katz, and New York University Law School. New York City is home to some of the Nation's preeminent bankruptcy judges and practitioners and also to some of the brightest, most complicated bankruptcy cases, often of national scope and importance. Indeed, probably every member of this committee has a constituent who at one time or another has had a stake, whether he knows it or not, in a bankruptcy case in the Southern District of New York. So I am pleased in particular to welcome Mr. Rosen from New York today.

And I want to thank you again, Mr. Chairman, for calling this hearing at this time. And now can you start the clock running, and I thank you for the opportunity to make this belated opening statement.

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Mr. **GEKAS.** You may proceed.

Mr. **NADLER.** I have a couple of questions. First I think it was Mr. Williamson, in your testimony, you talk about the different homestead exemptions in the States, and you mentioned that you defined the assets available to the distribution of creditors. The States would retain flexibility in a specified range in determining bankruptcy homestead exemptions, but the Federal Code would no longer authorize States to opt out, and you address the varying exemptions in the various States. Would you put a floor on this exemption or simply a cap?

Mr. **WILLIAMSON.** Mr. Nadler, we would put both a floor and a cap on homestead exemptions and leave it to the States to set an exemption limit in that range. This is an issue that the Commission is considering and has not yet come to a final recommendation.

Mr. **NADLER.** Thank you.

My second question--perhaps it shouldn't be a question, but urging that in considering this you take a look at variations in the cost of living. It is one thing when the State does this, but if we are go to a Federal homestead exemption statute, I think you should take a look at the widely varying cost of living and the widely varying cost of housing in different regions of the country. What might work in a low-cost area would be extremely restrictive in a high cost-of-living area, and vice versa.

My third question: Could you discuss for a moment the effect of the bankruptcy system on preserving jobs, in other words, on preserving jobs in companies threatened with bankruptcies, and any changes that you might recommend in this respect?

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Mr. **WILLIAMSON.** I do that, Congressman, by endorsing Mr. Rosen's comments and emphasizing that the principal reason that we have a chapter 11 reorganization system, rather than a corporate liquidation system, is primarily to save the enterprise and to save the jobs involved in the enterprise.

As Mr. Rosen indicated, chapter 11 on the whole works quite well. And when there are active creditor committees, chapter 11 works very well. As I have observed to the chairman, some people buy their clothes at stores that have come through chapter 11. We fly on airlines that have been through chapter 11. It is a very, very useful tool for preserving jobs and capital in this country.

Mr. **NADLER.** I have two further questions. The Supreme Court--I am not sure who to address this to. You can decide who this particular question is for. The Supreme Court in the case--the *Continental Airlines* case, I think, opened a much wider exemption than was previously recognized for companies to escape from union contracts via the bankruptcy route. Is the Commission considering doing anything about this, widening the ability to do so, narrowing the ability to do so, or any recommendations in this area?

Mr. **ROSEN.** As a result of this case and other cases, the statute was amended to make the possibility of rejecting union contracts much more restrictive. There are special standards to meet in order to reject. You must try to negotiate. It has to fail. You have to go back and forth a couple of times before you can have a rejection. I think you will undoubtedly hear from unions on the issue, but the statute has been amended since the cases that were viewed as abusive were filed, and it is now more difficult to try to reject.

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Mr. **NADLER.** And you are not likely to recommend any changes on that.

Mr. **ROSEN.** I have nothing to do with the Commission in that sense. I don't know what they are doing.

Mr. **WILLIAMSON.** That is an area that we have looked at, Congressman, but I don't foresee, subject to change, any additional recommendations in that area.

Mr. **NADLER.** Fine. Thank you.

I think, Mr. Rosen, it was you who mentioned that there are lots of small businesses in chapter 11 that probably shouldn't be there, and that small businesses that should be in chapter 11 find it very expensive, time-consuming and so forth.

Maybe I shouldn't ask you this. Could you recommend, and, members of the Commission, would you consider, perhaps, the idea that maybe we ought to have a special part of the court for small businesses, a part that would--because they are not dealing with large, complicated bankruptcies, but only the small businesses--could make the legal costs much less and the time also much less?

Mr. **ROSEN.** I don't know what they are doing, but I would like to try to answer it. The experiment with two chapters, which is what the law was under the old law, chapter 11 for small corporations and chapter 10 for big corporations, turned out to be a failure.

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I for one would not recommend separate chapters, but there are a few recommendations that should be looked into. One is to put provisions in chapter 11 for a small business to make it simpler to go through the chapter 11 process, and I think the Commission is working on that.

Mr. **NADLER.** I wasn't asking about a separate chapter; maybe with some separate provisions, but a separate part of the court so the judge would sit there and only handle small businesses.

Mr. **ROSEN.** I don't think so myself. I mean, there is already an objection to having a Bankruptcy Court separate from the district court. If you start dividing it down--you might say should the same judge handle consumer cases, which are totally different from business cases, along with business cases? I think it is okay to have the same court deal with all of them.

The other thing I would say is that one of the problems with small businesses is that a lot of them don't belong in chapter 11, and the system hasn't found a way to quickly weed out the businesses who really can't reorganize and get them into chapter 7 or wherever they belong. One of the points I failed to make in my oral statement, but it is in my written statement, is that there is a U.S. Trustee system, and the U.S. Trustee and the court to some extent should be encouraged to be more proactive in weeding out cases that don't belong in chapter 11 at an early stage.

Mr. **GEKAS.** The time of the gentleman has expired.

Mr. **NADLER.** Thank you, Mr. Chairman.

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Mr. **GEKAS.** We now recognize the gentleman from Massachusetts for 5 minutes.

Mr. **DELAHUNT.** Thank you, Mr. Chairman.

The testimony was very informative, and I want to commend Mr. Williamson for what obviously is a rather arduous undertaking.

To get back to the statistics on the charts there--and again, I am a new Member, and I am new to the bankruptcy system. I have not participated in it as an attorney, nor as an applicant, nor as a subject, I am happy to say. In any event, is it the Commission--is it part of your effort to conduct any kind of an economic analysis as to the causes for that sharp increase in terms of consumer filings?

Mr. **WILLIAMSON.** Congressman, we are not in a position to conduct an independent analysis, but what we have tried to do in a series of hearings is to invite a broad range of witnesses: academics, business people, and a representative of the Congressional Budget Office all have testified before us. He happens to be here today. So what we have tried to do is to get a range of testimony to help us understand the phenomenon so that we can responsibly answer the question that Congress has put to us: Should there be any change in the system?

Mr. **DELAHUNT.** Again, I am sure that we will get a very worthy answer to structural changes in the system, but I think beyond that, in terms of Congress and this committee, it would be very beneficial to have as part of your report the economic reasons for that dramatic increase.

Particularly in the last 18 months, what was the percentage, Mr. Williamson?

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Mr. **WILLIAMSON.** 27 percent, 1996 over 1995.

Mr. **DELAHUNT.** So in one year we went----

Mr. **WILLIAMSON.** 27 percent increase.

Mr. **DELAHUNT.** I think it is important in terms of even larger issues for Congress to look at as to whether that dramatic increase might very well be an indicator as to where we are going in terms of the economy. I certainly don't have that answer, but I would hope that the Commission would give it some thought and make it part of its record.

And just one other question, Mr. Chairman, if I can, in terms of those--and I would address this to Mr. Rosen, the issue surrounding the mass tort claims. Do you have any data for us in terms of how many companies have--or corporations have experienced difficulty in terms of that particular issue? Is there any hard data that we can look at?

Mr. **ROSEN.** I think there is. I don't have it, but I believe it has been said that the number of companies that went down by virtue of asbestos liability is something like 15 or 20 companies, including major corporations. Other cases, such as the *A. H. Robins* case involving the Dalkon Shield involve only one company.
The problem also arises in terms of small aircraft companies. I think Piper Aircraft is a case. You try to sell an aircraft company that made small planes. The question is what happens if a plane goes down 4 or 5 years after the sale due to some alleged defect when the plane was manufactured 10 years before? Can the buyer protect itself against liability for that claim? If not, the aircraft company could have difficulty selling itself and a liquidation may result to the detriment of all concerned.

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Mr. **DELAHUNT.** I think it would be beneficial to have that information. You could make a submission to the Chair or the committee.

Mr. **ROSEN.** It isn't a large number of cases, but I think there are significant cases involving a large number of people and a large amount of money.

Mr. **DELAHUNT.** I had one other question, I apologize, but I would like to address this to Mr. Case.

You were referring to John Connolly when he was Secretary of the Navy, when he was a Democrat; is that correct?

Mr. **CASE.** I believe so. Yes.

Mr. **DELAHUNT.** And then you stated as Governor he was a Republican?

Mr. **CASE.** As a Republican, he was Secretary of the Treasury.

Mr. **DELAHUNT.** And what was he when he did file for bankruptcy?

Mr. **CASE.** I am not sure, Mr. Delahunt.

Mr. **CONYERS.** I think he was independent.

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Mr. **GEKAS.** The Chair recognizes the presence of the gentleman from Michigan, Mr. Conyers, who is a long-time Member of Congress and now the ranking minority member of the Judiciary Committee. We also acknowledge the presence of Ms. Jackson Lee of Texas, a member of the subcommittee. And we recognize the presence of the gentleman from South Carolina, Mr. Inglis, and we turn our attention to Mr. Bryant for his allotted 5 minutes.

Mr. **BRYANT.** Thank you, Mr. Chairman.

I suspect he was probably a Democrat, being the free-spending person that he was at the time of the bankruptcy. Just kidding.

Before I make a short statement and ask a couple of questions, I want to introduce not formally, as he will be introduced later, but recognize on my part Judge George Paine from the Middle District of Tennessee, a very fine, outstanding bankruptcy judge; and also George Stevenson who is a friend of mine from the western part of the State, a bankruptcy trustee, both gentlemen very knowledgeable on this subject. Thank you for being here.

Having practiced in bankruptcy in a prior life, I have a lot of preconceived notions about bankruptcy, and our record in west Tennessee, was one of the top nationally in chapter 13 filings.

The slant, Mr. Williamson, you put on it is good. I never thought about it as being one we would want to emulate simply in terms of numbers of bankruptcies. That is disturbing, but given the choice between a chapter 7 and a chapter 13, I would recognize the importance of people trying to go the chapter 13 route if at all possible.

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In large part, the problems that we are seeing in bankruptcy filings across the country are societal, certainly the amount of debt and so forth and those things that are available. And there is enough blame to spread around to all parties but certainly society's stigma that formerly was attached to filing bankruptcies is clearly absent in this day and age to the point that very often it is one of the first options that people look at when they get in debt. It may be that the very first option is bankruptcy rather than how can we get out of this without filing bankruptcy and ruining our credit record.

Also in terms of the direction that people go in terms of chapter, 7's and chapter 13's, may in large part be dictated by the attorneys. I know the attorneys' obligations in bankruptcy and their requirements, but nevertheless, I think we have an outstanding, bankruptcy bar, in west Tennessee, and probably have a slant toward chapter 13's, of which we saw an awful lot.

There are several questions I would like to ask on the case overload, Mr. Case, and Mr. Rosen, how you would suggest we reform appeals, for instance, and frankly, we probably don't have a lot of time to cover that. I would like to come back to that if we could. But, Mr. Williamson, I would like to ask you quickly if you could answer this, we could come back to the other ones.

I haven't read the draft report of the Commission's findings, but in a chapter 13 and a chapter 7 situation, is it possible to place into the existing system a point where these cases can initially be evaluated and a requirement be made that it be filed a certain way given the chances of not a reorganization, but chapter 13 being successful? And if so, who would do that, and how would that fit into the scheme?

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Mr. **WILLIAMSON.** The first part of your question, Congressman, is easier to answer than the second part. The Commission has heard testimony and has seen several proposals to establish a benchmark at which a person, at least presumptively, would have to go one route or the other--chapter 7 or chapter 13. And, of course, there is a difference of opinion--a strong difference of opinion--on where that benchmark should be set, and, in fact, a difference of opinion about whether it should be presumptive merely or rather mandatory. The goal here, according to the testimony in the proposals, is to ensure that people received the bankruptcy relief they needed, but no more.

I think it is fair to say that we have heard a substantial amount of testimony that chapter 13 is the better of the two choices from an economic and societal standpoint. Why? Because the theory is that in chapter 13 more people would repay more debt.

One problem with that is the "failure rate"--and I put that in quotes, because it is a definitional problem as well--in chapter 13 is quite high, whether it is half the cases or two-thirds of the cases nationwide. So then you have a situation where someone starts a chapter 13, hopefully in good faith, has a repayment plan of 50 cents on the dollar and for a whole host of reasons doesn't complete it. In that case, there is no discharge. The process in that case has not worked in the sense that the plan has not been fulfilled.

Now to get to the second part of your question, the mechanism for doing this is really quite difficult to divine unless, of course, you simply say above a certain income level or a certain debt level, everybody goes into one chapter. If you make it presumptive and let the judge make a decision, then you are increasing the workload, which gets to your next point.

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Mr. **BRYANT.** Thank you.

Mr. **GEKAS.** The time of the gentleman has expired. We turn to the gentleman from Michigan, Mr. Conyers, if he wishes.

Mr. **CONYERS.** Mr. Chairman, could I let Ms. Jackson Lee precede me?

Mr. **GEKAS.** Certainly.

We recognize the lady from Texas.

Ms. **JACKSON LEE.** I thank Mr. Conyers, and I thank the chairman very much, and certainly welcome this very important discussion.

I come from--I represent Houston, so I come from the Second District of Texas, and I can just note the certainly proliferous filings that certainly occurred in that area may be comparable to many other areas around the country, but I remember very clearly during the time of extensive downturns in the energy industry, the 1980's. If there is a terminology of "belly up" and "flapping with no water," this was an equal opportunity offender. And we were competing for getting in line between small businesses, independent single entrepreneurs, personal families and large corporations.

So I think that this is an important discussion as to how we can make this work for those for whom it needs to work. And I have some questions, and I appreciate very much, Mr. Williamson, your work, certainly having followed Congressman Synar and his great commitment and work in this area.

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I would like to ask the question about how we relate to the question of stigma. I just read this article, "Deadbeat Nation." I take great offense from this particular article, and I would like, gentlemen, for you to comment, one, on any terminology of that sort. I think a deadbeat Nation goes more to the fact that we need to create a Nation of makers of something. We need to move more from the service economy instead of suggesting that our citizens are deadbeat because they have financial problems.

I also take offense with our great credit card promoters because they are as much part of this. They want a harsher Bankruptcy Code, and yet there is not a fly on the wall that cannot get a credit card. So I am not sure what their approach to handling this, other than to recognize they have a basic problem.

Could you answer the question about stigma as it relates to those who file? Mr. Case, could you also answer the question about your friend who tried to file chapter 11 and was frustrated?

And let me answer the question about Mr. Connolly. I was there in living color in terms of the timeframe or the atmosphere. It was immensely emotional. It was a big story in Texas. There was a lot that was taken away from that family that we considered, whether we were Democrats or Republicans, a great contributor to the history of this country.

So, how do we handle the abuse, the stigma question, and how do we make it more workable for those who are truly in need of filing bankruptcy?

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Mr. **CASE.** I cannot give you a lot of personal experience about personal stigmatization. The Governor of Arizona, as we speak, is a debtor in a chapter 7 preceding during the period of his incumbency. I believe he is running for reelection.

Ms. **JACKSON LEE.** That will be the test.

Mr. **CASE.** That will be the one test for at least a public official suffering the distress.

I think the American--who am I to generalize--but I think the American people are on the whole a forgiving people with good hearts, and bad things happen to people, and I don't see a great deal of spending your life wearing a "Scarlet A" because we have been through a bankruptcy proceeding. The harder part of it is simply parting with possessions and having to admit that you went through bankruptcy.

I mean, my dentist's nurse the other day was telling me that 10 years ago she had to go through a bankruptcy proceeding, and I think even 10 years later she felt ashamed that she had had to do that to solve a problem. But she didn't say that nobody would speak to her and she was some kind of second class citizen.

Ms. **JACKSON LEE.** Can others respond from the financial institution's perspective, getting loans, any impact? Let's just say from my community's perspective, particularly in the African-American community, I am hearing issues of credit, making amends to get a home later on in life, et cetera, those kinds of things.

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Mr. **ROSEN.** I cannot answer on consumers. There has been some talk about there being no stigma for businesses going into bankruptcy. I was going to address that.

I don't find in my own experience, notwithstanding publicity and news stories, that any business wants to go into chapter 11. It is true that it is a remedy and that it can be effective, but on the other hand any time somebody goes into court, particularly chapter 11, someone who was previously running a company now has to deal with a judge and a U.S. Trustee and a creditors committee, it is extremely unpleasant. Someone did statistics that showed that of chief executives of companies that go into chapter 11, only 25 percent survive the process. Usually they are discarded somewhere along the way.

So I think the idea that it has lost the stigma is wrong. I don't think it has lost the stigma. People are forgiving but it is not a step people take lightly. Most people don't know what it is. They don't want to go near it. They don't want to be involved with people who have control over them. I just don't think that is true.

Ms. **JACKSON LEE.** Mr. Chairman, might Mr. Williamson make a sentence comment on my question?

Mr. **GEKAS.** Without objection.

Ms. **JACKSON LEE.** Thank you.

Mr. **WILLIAMSON.** Certainly, we have heard a lot of testimony about this issue of stigma, but I think it is important to remember that the essential choice that consumers have in bankruptcy today was the same choice they had in 1938, because the bankruptcy law for consumers, has been essentially unchanged since the Chandler Act 60 years ago.

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We have a number of people who have asked us as a Commission: the law has changed or the law has gotten easier, hasn't it? And I think the only fair answer is that while the law has changed here and there, it is essentially the same. What has changed dramatically is the American economy and the American way of borrowing. That has been a wonderful development in terms of economic growth and prosperity. But the bankruptcy system--and, Congressman Bryant, I think this goes to your question as well--ends up being the hospital where society takes care of either economic misfortune, simply bad luck, or economic poor judgment, whether by borrowers or lenders.

Ms. **JACKSON LEE.** Mr. Chairman, may I submit in the record an opening statement by unanimous consent. I would like to ask that my opening statement be submitted in the record.

Mr. **GEKAS.** Without objection.

Ms. **JACKSON LEE.** Thank you.

[The prepared statement of Ms. Jackson Lee follows:]

PREPARED STATEMENT OF HON. SHEILA JACKSON LEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, I would like to thank Chairman Gekas for holding this hearing on the operation of the bankruptcy system so that this committee may receive a status report from the National Bankruptcy Review Commission. I look forward to hearing from the Commission's Chairman, Mr. Brady Williamson, and the four bankruptcy experts that the committee has assembled today to discuss the vast bankruptcy system. Just recently, it was reported by the Administrative Office of the U.S. Courts on March 18th of this year, that the total filings for the year were over 1.17 million. These filings represent an all time high which is an increase by 27.7% since the same period last year. In 1996, there were over 13,000 reported filings in the Southern Judicial District, which sits in my congressional district of Houston, Texas, and that figure saw a jump last year from over 14,000 to over 17,000 in that judicial district alone. While these figures are indeed staggering, what is most important however, is what are the causes of these many filings?

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On a survey taken recently by the National Bankruptcy Review Commission which polled both creditor and debtor representatives, five primary causes were cited by two-thirds of the respondents. They were the ease of obtaining personal credit cards, loss of a job, financial mismanagement, medical problems, and martial/family problems. In the ten largest cities, the leading causes were job loss, business/employer failure, and catastrophic events. While I understand that many in the creditors' community believe that there are abuses in the bankruptcy system, the survey results conducted by the Commission point out that although abuse is a problem in our current bankruptcy system, it is not rampant. I represent a congressional district in which the make-up of the population is predominantly African-American low to middle income families. While the majority of the population might not be homeowners, those who do own homes, have worked awfully hard to obtain this American dream. While the bankruptcy system might need some "reform," I want to insure that reform is equitable and fair and that it does not leave the homeowner who may have come under sudden financial strain due to job loss without his home, or make it harder for someone to liquidate one's assets, or almost impossible for the small businessowner to reorganize his debt through chapter 11 of the Bankruptcy Code. It is imperative Mr. Chairman that true "bankruptcy reform" be both fair and equitable for all Americans.

Mr. **GEKAS.** The Chair now recognizes the gentleman from South Carolina, Mr. Inglis.

Mr. **INGLIS.** Mr. Chairman, I would be happy to yield to the gentleman from Tennessee, Mr. Bryant, for additional questions.

Mr. **GEKAS.** Without objection.

Mr. **BRYANT.** Thank you, Mr. Chairman. Thank you, Mr. Inglis.

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Let me, if I could, follow up, Mr. Case, other than the obvious way of Congress adding more funds and more judges, is there a way within the existing system and numbers that we can handle the cases more efficiently? I know they are doing an outstanding job already but are there other mechanisms?

And maybe I should open that up to additional moneys and so forth. I know that in the article 3 arena, we have magistrate judges that now come in and handle a lot of matters. Would something comparable to that work in Bankruptcy Courts? I know the trustees are doing things already. Do you have any immediate suggestions?

Mr. **CASE.** Well, there is a radical idea which I don't think has any wide support but that is occasionally discussed, and that is to make the chapter 7 discharge for the run of the mill case a nonjudicial remedy, granted by someone in the Justice Department, such as the U.S. Trustee, and to take all the filings and all the work on those cases out of the judge's chambers.

Mr. **BRYANT.** Mr. Williamson.

Mr. **WILLIAMSON.** One of the difficulties with that kind of proposal is it would lessen the stigma, rather than increase it because, at least in the current system, you know that you may have to go before a Federal judge. Most, if not all, of the Federal judges I am acquainted with make it very clear to the people who appear before them that it is a very serious matter and that bankruptcy is a Federal process. The bankruptcy judge hopes they will never have to go through it again.

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If you make part of the process purely administrative, it would be almost like Social Security, and I think that would not advance us in the long run.

Mr. **BRYANT.** Mr. Rosen, if I might address the issue, and I want to be clear, a moment ago when I spoke of stigma, I think I couched it in terms of chapter 7's and 13's, more toward the individual as opposed to the reorganization efforts. I totally agree with you in terms of there being no remaining stigma with business reorganizations.

You mentioned in your testimony about the appeals process, and how that could be sharpened.

Mr. **ROSEN.** Yes, I don't pretend to be an expert on appeals or jurisdiction, but I think the Commission has, in fact, worked out a proposal of skipping the district court in the appeals process so you would go straight from the Bankruptcy Court to the court of appeals and that would eliminate one appeal in the process, and I think everyone involved in the system viewed it as desirable to cut down on the amount of litigation and the amount of appeals.

I am sure there are problems with that, but it seems to me that it is desirable to only have a single appeal to the court of appeals from the bankruptcy system.

The other part of that is the question of whether there should be article III judges in the bankruptcy court, which is a longstanding controversy. The original proposed legislation coming out of the House, I think in 1978, proposed article III status, and then I think the Senate disapproved of that, and then eventually it was dropped in the course of the passage of the 1978 legislation. I think the Commission is going to take a position on that question as well.

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Mr. **WILLIAMSON.** Congressman, on the appellate process, we do have a tentative recommendation that would do precisely what Mr. Rosen says. We have discussed that with the subcommittee's counsel, and it may be something that the subcommittee wants to review before the Commission submits its work.

Mr. **BRYANT.** Mr. Chairman, I yield back.

Mr. **GEKAS.** The gentleman from Michigan, Mr. Conyers, is recognized for 5 minutes or more, depending on your attitude.

Mr. **CONYERS.** Thank you, and also my deportment. As a signer of the Hershey accords, I want you to know that I am on my best behavior since I was in your congressional district, Chairman Gekas.

Well, we welcome you. There are three things that I would like all of you to take a crack at. One is--I hope this is not too political, but you know when the Federal judges who are not supposed to lobby start calling us about this title III business, a lot of the Members are going to say, well, Ms. Lee, you know, how do you know more than the judges in your district? I mean, they don't want this. And even though you smile upon it, and perhaps many of us do here, it gets into quite a contest.

The second thing that occurs to me is that we ought to look at our bankruptcy situation as compared to other western style, capitalist style economic systems. And I would like any of you that want to comment about that.

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And then there is the old dollar cap problem that still bedevils us. You could have Rockefeller Center the subject of a quick foreclosure without some kind of a cap. So I am anxious to hear your comments about that.

Mr. **WILLIAMSON.** I will be quick and try to touch each of the three.

With respect to article I versus article III status, the Commission will have a recommendation in its report in that regard and will include a transition plan, if Congress accepts the notion that article I judges status should be eliminated in favor of article III status.

Mr. **CONYERS.** Thank you. That will make our life a little bit better.

Mr. **WILLIAMSON.** With respect to your comment about comparisons with other Western nations, I will leave that to Mr. Rosen. He devoted a part of his opening remarks to that.

Third, with respect to the cap, as the Congressman knows, since he is the author of a bill that involves that subject, this subcommittee is going to have a hearing on that, among other things, on the 30th of this month. I don't think the Commission will have a position on that particular aspect of the technical bill.

What we will do is include, in part of our recommendations, a broader approach to that problem--single assets, the use of the automatic stay--and, of course the small business fast track that the Chairman asked about.

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Mr. **CONYERS.** Thank you.

Mr. **ROSEN.** With respect to comparison of other systems, our system is different because our chapter 11 is more forgiving and gives a reasonable opportunity for rehabilitation to an honest debtor and honest management. I think the rest of the world hasn't been there. The rest of the world has come around somewhat. England and Canada have modified their statute in recent years. I was involved in discussions with people from the German and Swedish Legislatures thinking about trying to pick up ideas from our chapter 11. So I think that our system has been different, but it has been a more forgiving and a system that looks to rehabilitation, looks to saving jobs and saving businesses to a greater extent than systems in other countries, and I think ours is the better idea.

On the other hand, given 20 years of experience under our Bankruptcy Code, I think there are some things in our system that should be adjusted, but nothing major. The system I think is basically all right in terms of businesses.

Mr. **CASE.** Mr. Conyers, if I could address briefly your questions in reverse order.

The dollar cap on real estate cases is a very difficult issue. One side of that debate says, oh, real estate foreclosure is a two-party litigation, there is no great issue about preserving jobs and going-concern value, and it is an abuse of chapter 11 to let it be there. The other side says why should the real estate investor have less of a chance to protect himself in chapter 7 than anyone else? Tough question for you.

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As far as other countries are concerned, I believe there is a trend, incipient but recognizable, around the world to move industrial insolvency laws toward the U.S. model, because the governments and the policymakers in the other countries have discovered how effective it is to preserve jobs and going-concern value.

I won't add anything to the article 3 debate that my colleagues haven't said.

Mr. **CONYERS.** Well, you told me it was a tough question for me, but what is it for you?

Mr. **CASE.** A tough question.

Mr. **CONYERS.** Tough one for you, too?

Mr. **CASE.** I think if I had to make a personal decision, I would go toward making it more restrictive to have real estate cases in chapter 11. I think there is too much opportunity to abuse it, drag it out, and postpone the day of reckoning in many cases simply to postpone the date for having to pay Federal income tax.

Mr. **CONYERS.** Thank you all very much. Thank you, Mr. Chairman.

Mr. **BRYANT** [presiding]. Thank you. We yield 5 minutes to the gentleman from Massachusetts.

Mr. **MEEHAN.** Thank you, Mr. Chairman.

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I am pleased that the subcommittee has taken the time today to review both the operation of the current bankruptcy system and the National Bankruptcy Review Commission's progress in developing recommendations in reforming that system.

It seems to me that the challenge that we face over the upcoming months is, one, the bankruptcy system to deal with recent bankruptcy trends, particularly the explosion of both consumer and bankruptcy filings and mass tort bankruptcies. We also need to remedy the current abuses on the part of both debtors and creditors to improve bankruptcy administration.

Thankfully, it seems to me, this should be a manageable task because our current--as the witnesses have indicated, our current bankruptcy system works well for the most part. In December 1996, the American Bankruptcy Institute report on the state of the American bankruptcy system found that half of the bankruptcy professionals surveyed considered our system to be excellent or very good, while another 37 percent rated it good. So I think that is certainly a compliment to the legislators, the academics, and the professionals who worked on the Bankruptcy Reform Act of 1978, which created much of our current system, and I would hope, with the guidance of the National Bankruptcy

Review Commission, I do not have any doubt that our efforts in the upcoming months will be similarly well received.

In the area of particular concern to me is how chapter 11 deals with bankruptcies based solely on a firm's being subject to substantial mass tort liability. We have already seen a number of these cases, particularly in the context of asbestos to breast implant liability. We will undoubtedly see more of them in the years to come, particularly as product liability plaintiffs finally begin to rack up well-deserved judgments against tobacco companies.

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I am concerned that when companies involved in mass tort liability file for chapter 11, injured plaintiffs are going to have to wait for a long time before recovering damages. Lengthy procedures might destroy an otherwise healthy business costing men and women their jobs.

So my question is, what should be done to create a fairer structure for the treatment of creditors and debtors? And also, when bankruptcies are occasioned by mass tort liability, how are we going to create this fair treatment?

The second part that I am interested in has to do with the discharging of debts. Currently, there are a number of debts that are under the Bankruptcy Code that are termed "nondischargeable," things like income tax debts that are based on fraudulent returns, debt incurred by embezzlement or larceny and child support and alimony. Clearly, there are going to be proposals to expand and contract this list of nondischargeable debts.

So in considering these proposals, I am wondering if you could let us know what would be helpful for us in terms of having some kind of set of principles in mind that would explain what we should allow in terms of certain debts to survive bankruptcy? And could you elaborate on what those principles would be that would guide us in determining which debts should be nondischargeable?

Mr. **ROSEN.** I can try to answer the mass tort question, which I will do.

I am a member of the National Bankruptcy Conference, and was chairman of it for a number of years, and the National Bankruptcy Conference, nothing to do with the Commission, has in fact had a future claims project running for 4 or 5 years and has come up with a series of proposals in an effort to deal with making chapter 11 a vehicle that can be used for the mass tort problem if it reaches the stage where the company has failed.

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Essentially, the elements of what is needed in future claims is the fact that you need a new definition of a claim. One of the problems is that people don't have claims as normally defined now if they worked in an asbestos plant 20 years ago and are not yet sick. So you have to expand the definition of "claim" so as to pick up all people who are possibly injured, including people you don't know about yet, and define them as a claim.

The second thing you have to do is get them a representative because they are not around and you can't simply send a notice. Doing a notice by publication doesn't work. You have to give the court the authority to appoint a representative who will represent those future claimants in the case.

The next step really is to say that when the pot gets divided, the court has to make a determination as to what the aggregate of the liabilities may be, including those future claimants, and has to make sure that enough is set aside to cover not only the current claimants but those that will emerge in the future.

To some extent, you are dealing with estimates, and it is not going to be a perfect system, but the current statute has to be stretched quite a bit to accommodate those needs. But in fact in the cases that have already occurred, such as the *Dalkon Shield* case, courts did appoint representatives. They did try to expand the definition of claim. They did all of the things I am describing, but they did them without adequate statutory support, really.

You can bring the statute up to date by following the example of what has been done in some of the cases that have come through and make the result more certain. Try to get representation for these future claimants, and make sure that they are adequately provided for when they emerge.

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Mr. **GEKAS** [presiding]. The time of the gentleman has expired. However, we will give the gentleman an additional minute.

Mr. **MEEHAN.** Again, I asked the question on dischargeability of debts. I wonder if you could give me an idea of what those principles might be.

Mr. **CASE.** With the chairman's permission, I would offer this answer. The inside slogan in American bankruptcy law for individuals for decades has been "A fresh start for the honest debtor," and I would personally favor a great reduction in the number of exceptions to discharge in the statute. It produces litigation over whether the debtor gets out of the debt or not. And every new exception to discharge creates another exception to the fresh start and leaves bankruptcy as a mechanism that does not solve the problem for the debtor.

Mr. **GEKAS.** The time of the gentleman has now truly expired.

The panel has the gratitude of the Chair and the members of the subcommittee, and has the additional burden of knowing that we may call upon them at any given time for further expertise.

We now call the second panel to the table which consists of Judge Paine, who has been already introduced by the gentleman from Tennessee. He is a graduate of the University of Mississippi Law School. In 1981, he was named to the U.S. Bankruptcy Court for the Middle District of Tennessee and since 1984 has served as Chief Judge of that court.

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He received the Bronze Star and the Purple Heart while serving as a platoon leader in Vietnam. From 1988 to 1989, he served as president of the National Conference of Bankruptcy Judges and for 4 years as vice president of the American Bankruptcy Institute. He is also on the faculty of the Federal Judicial Training Center. And among his many extracurricular activities, I note from his résumé, that he is also a 12-gallon blood donor to the American Red Cross. We need you.

With him is Charles M. Tatelbaum. In his student days, he was a member of the editorial board of University of Maryland Law Review. Mr. Tatelbaum now practices with the law firm of Johnson, Blakely, Pope, Bokor, Ruppel & Burns in Tampa and Clearwater, FL.

Since the early 1970's, he has been an extraordinarily prolific author and lecturer in the field of bankruptcy. He has been a member of the board of directors of the American Bankruptcy Institute since 1985 and its vice president since 1991. Mr. Tatelbaum has prepared a very comprehensive statement for us today on behalf of the American Bankruptcy Institute, which should prove to be a useful reference for members of the subcommittee.

May I repeat that all written statements and other accompanying features of your testimony will be made a part of the record, without objection, and Mr. Tatelbaum will begin the testimony.

Mr. **CONYERS.** Mr. Chairman, could I apologize, I am going to have to leave, but I want the witnesses to know I am going to read their testimony.

Mr. **GEKAS.** Without objection, we will make sure that you get copies, Mr. Conyers.

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Mr. Tatelbaum, you may proceed.

STATEMENT OF CHARLES TATELBAUM, ESQ., VICE PRESIDENT FOR RESEARCH, AMERICAN BANKRUPTCY INSTITUTE

Mr. **TATELBAUM.** Thank you, sir.

I appear on behalf of the American Bankruptcy Institute and I have the honor of being its vice president of research.

The ABI has over 5,500 members, including attorneys, accountants, judges, bankers, credit managers, trustees, academics, and financial services professionals. We are nonprofit, nonpartisan, and our primary function is to assist this body, the legislative body, in promoting the bankruptcy law to a system.

I am very pleased to have had the opportunity of testifying before this committee before for the ABI.

I thank the Chair for the kind words about our written presentation, and we hope that the written materials will aid the subcommittee in its work, and we stand ready to be a resource as the subcommittee needs us. I really will just simply highlight some of the issues that I think are significant.

The system is working. However, some things have changed in the last 20 years. There are conflicts between the different circuit courts of appeal that may need to be resolved on a legislative basis. There are conflicts with other laws, mostly from Congress, that need to be resolved. And the financial environment has changed and the attitude toward bankruptcy has changed.

This was the headline in my paper in Florida last week. It says, "With the Number of Personal Bankruptcies Swelling to Tsunami Proportions, What, If Anything, Can Be Done To Keep Consumers From Drowning in Debt?" And there is a giant picture of a tsunami wave. I think that part of this is an attitude, as the Congresswoman questioned.

A very quick vignette. I think stigma has changed completely from the 1940's and 1950's. When I was growing up in Maryland they had to pass a law to prohibit a thing called a "shame car," which is where they would park a car in front of someone's house with a sandwich board on it with a big finger pointing to the house and it said: The people in this house owe the HUB Department Store and are debtors. The shame was so bad that that was deemed to be an unfair collection practice and it was banned in many States.

Today, there is no shame because everyone is a debtor. It is a way of life. Some of it has to do with lawyer advertising, which answers some of the questions before. This comes from a paper from northern Virginia. A free paper. The first half is: "Are you drowning in debt? We can help. Bankruptcy." And it tells you why bankruptcy works. And the second half of the page is an ad from a car company that says, "If you have been bankrupt, we will give you a car if you have a job."

And I think part of what has happened, and the statistical analysis--and we have a number of charts at the back of our materials from our membership survey which is quite extensive--shows that the stigma is not there. Consumers go to the lawyers who advertise, who may not tell them all of the problems that exist, and there is a perception, maybe not the reality, that it is a quick fix and they can get out and get a car and get started again.

There is a perception of no adverse consequences. We have a good economy. There is much more consumer spending, and when there is more spending, there are more bankruptcies and credit availability is very much loosened.

I think that what the ABI is suggesting is that this subcommittee needs to consider a new Bankruptcy Code for the new millennium to correct and deal with the current and future needs.

In our written materials, we talk about good faith/bad faith filings; mandatory chapter 13's; the abuse of the system by debtors. There is also a perceptive abuse by creditors. This was a headline in many of the papers on Friday where Sears agreed to some $500 million to debtors who they improperly collected from post bankruptcy. Beyond the Bankruptcy Code, and I call the subcommittee's attention to the Fair Debt Collection Practices Act, which is almost completely abused in many instances by creditors, the system is not working because the law isn't working, it is because the enforcement may not be there and maybe we need some new enforcement mechanisms.

Exemptions, the subcommittee has talked about that. That really does need to be addressed. As one who practices in Florida, I recall "60 Minutes," and some of the other shows have demonstrated some of the perceived abuses of the States with big exemptions.

Dischargeability. As the previous panel talked about, we have a major issue dealing with student loans. And that is a very significant problem. They used to be dischargeable under chapter 13 to make an incentive to go to chapter 13. Now they are not. Do you want to have a student loan discharge so that people do have an incentive to go to chapter 13? That needs to be done.

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Very quickly, we have gone through all of the areas, and, if I may, there is one urgent issue that the subcommittee may need to look at. That is the fact that on April 28 of this year the Bankruptcy Courts in the Virgin Islands are going to shut down as a result of a decision by a district judge there. And I urge the subcommittee, to take a look at this situation because it will take a legislative solution, not a judicial solution.

[The prepared statement of Mr. Tatelbaum follows:]

PREPARED STATEMENT OF CHARLES TATELBAUM, ESQ., VICE PRESIDENT FOR RESEARCH, AMERICAN BANKRUPTCY INSTITUTE

I am Charles Tatelbaum, a shareholder and chair of the Creditors Rights/Bankruptcy Department in the Tampa/Clearwater law firm of Johnson, Blakely, Pope, Bokor, Ruppel & Burns, P.A. I am appearing on behalf of the American Bankruptcy Institute, presently serving as its Vice President of Research. The ABI is the nation's largest multi-disciplinary organization devoted to research and education on issues related to insolvency. We have over 5,500 members, including attorneys, accountants, judges, bankers, credit managers, trustees, academics and financial service professionals. The ABI is non-profit and non-partisan and we generally take no advocacy positions before Congress, although we regularly appear to assist Congress' understanding of our nation's bankruptcy laws. We are honored to be here this morning to help increase the Committee's awareness of current issues affecting bankruptcy. The following is a summary of important but essential elements of bankruptcy practice and law, which serve to highlight the significant issues that will be brought before Congress in the near future.

GENERAL OVERVIEW

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Bankruptcy is booming in America like never before. In 1996, a record 1,178,555 new bankruptcy petitions were filed by both business and consumers. This was a 27.2 percent increase over total bankruptcy filings in 1995.

Consumer bankruptcy filings continue to drive the increase, as more than 95 percent of all cases (1,125,006) were by individuals and households, up 28.6 percent from 1995. Consumer filings have been rising in the wake of a sharp increase in the debt load carried by individuals and households. Consumer debt service as a percentage of disposable personal income has grown steadily since late 1993. (See attached chart.)

Moreover, the trend suggests that filings in 1997 may set another record: the fourth quarter of 1996 marked the highest three month total ever and the second consecutive quarter that total filings averaged over 100,000 per month.

Although business bankruptcy cases have been relatively flat by contrast (only a 3 percent increase in 1996, to 53,549 total filings) these cases frequently involve the redistribution of billions of dollars in assets. The life and death of companies are at stake in every sector of the economy and every state in the union. The 10 largest cases filed in 1996, for example, covered sectors as diverse as retailing, high technology, financial services, health care, energy, manufacturing, children's entertainment and brewing(see footnote 1) and over $8 billion in assets.

Arguably, a fundamental shift is occurring in American commercial life. Bankruptcy, once considered a likely prospect for only marginal or start-up concerns, is now something to be dealt with by all business people. Virtually all businesses have had some dealing with a bankruptcy entity, whether as a creditor or debtor. The issues being resolved in U.S. bankruptcy courts are complex and run the gamut from mass torts, underfunded pension plans, environmental disasters, financial frauds, international disputes, and more.(see footnote 2)

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The complexity of the business cases, and the raw volume of consumer cases, are resulting in some strain on the U.S. bankruptcy courts and administrative staff. With more individuals and businesses looking to the bankruptcy law for relief, it is important to understand the bankruptcy code's development, purposes and principles.

HISTORY AND PURPOSES OF BANKRUPTCY

Our legal system for administering insolvency cases dates back to the U.S. Constitution, which, in Article 1, Section 8, Clause 4, empowers Congress "to establish ... uniform laws on the subject of bankruptcies throughout the United States." Congress exercised this power by enacting bankruptcy statutes in 1800, 1841, and 1867 to deal with the effects of specific economic downturns. Viewed as temporary remedies, however, these laws were repealed once economic conditions stabilized. It was only upon the enactment of the nation's first comprehensive bankruptcy statute, the National Bankruptcy Act of 1898, that bankruptcy became a remedy available "continuously in the United States, in good economic times and bad."(see footnote 3)

The National Bankruptcy Act of 1898 governed the administration of bankruptcy cases until it was repealed by the Bankruptcy Reform Act of 1978 (as amended, the "Bankruptcy Code").(see footnote 4) Although the 1898 law initially contemplated only liquidation of a debtor's non-exempt assets, amendments to this statute in 1938, known as the Chandler Act, established debtor rehabilitation as a viable alternative to liquidation.(see footnote 5)

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The Bankruptcy Reform Act of 1978 is the most significant development in modern bankruptcy law. It creates a uniform procedure for business reorganization and modernizes the consumer bankruptcy provisions. It also establishes bankruptcy courts separate from the United States District Court system. The Bankruptcy Code was the product of more than a decade of drafting and debate. Spurred on by a series of very critical studies, Congress eventually enacted the Bankruptcy Code notwithstanding severe criticism from creditor groups who found its provisions too debtor-oriented. Criticism of the law continued after its enactment, culminating in the enactment of significant amendments in 1984.

The impetus for the 1984 amending legislation the case of *Northern Pipeline Co.* v. *Marathon Pipeline Co.*, 458 U.S. 50, 102 S. Ct. 2858 (1982). In *Marathon*, the Supreme Court declared unconstitutional the jurisdiction granted to Bankruptcy Judges under the Bankruptcy Code. In response to this decision and other pressures, Congress enacted and passed the Bankruptcy Amendments to this decision and other pressures, Congress enacted and passed the Bankruptcy Amendments and Federal Judgeship Act of 1984. While these amendments were necessary to cure the Marathon jurisdictional problem, they also made a number of changes in Bankruptcy Code provisions pertaining to consumer cases designed to tighten perceived abuses by consumer debtors in the area of exemptions and discharge under Chapter 7 and 13 of the Bankruptcy Code.

The Bankruptcy Code was further amended in 1986 with passage of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, legislation which made the U.S. Trustee system national in scope (with the exception of courts in North Carolina and Alabama) and enacted a new Chapter 12 to deal with the adjustment of debts of a family farmer with regular annual income; and in 1990, with certain miscellaneous amendments affecting principally commercial transactions.

Other minor amendments to the Bankruptcy Code since 1978 have addressed various subjects, including retiree benefits, international interest and exchange rate swaps, executory contracts, licensing rights to intellectual property, dischargeability of student loans and criminal restitution.

Prompted by continued, heated criticism from various groups, including creditors, and to address certain concerns that were not contemplated previously in the Bankruptcy Code, the Bankruptcy Reform Act of 1994(see footnote 6) was enacted, adopting comprehensive amendments to, among other things, improve bankruptcy administration; address commercial, consumer and governmental bankruptcy issues; and to establish the National Bankruptcy Review Commission.

The nine-person Commission is completing its two year project to study and recommend to Congress changes in the bankruptcy system in the United States. As a result of the expansive outreach of the Commission to receive input from all facets of bankruptcy related issues, it is anticipated that the Commission report will attempt to deal with the areas most in need of change. Since in most cases the Commission's report will not provide legislative drafting to implement the Commission's recommendations, it is especially important that this Committee and its staff be familiar with the underlying concepts involving the issues to be raised by the Commission report.(see footnote 7)

The Bankruptcy Code serves several major purposes. First, it provides an orderly process for the liquidation of assets of a debtor and the distribution of the proceeds of the liquidation of those assets in an equitable fashion to the creditors of the debtor. The Bankruptcy Code also supplies the mechanism for granting a discharge to the debtor from debts, thereby providing the debtor with a "fresh start" in life with those assets that the bankruptcy law exempts from distribution to creditors. In addition, the Bankruptcy Code provides a debtor, either corporate or individual, with the opportunity to rehabilitate or reorganize, rather than liquidate, provided the debtor pays creditors all or a portion of the obligations owed from future earnings.

UNDERSTANDING TITLE 11 OF THE UNITED STATES CODE

Title 11 of the United States Code contains all of the substantive direct law involving bankruptcy.(see footnote 8)

A brief overview of the current chapters to Title 11 may provide some general assistance.

Chapter 1

This chapter is entitled "General Provisions" and provides definitions of terms used in Title 11, reviews the powers of the court and other general matters dealing with the provisions of the Bankruptcy Code. The provisions of Chapter 1 apply to all chapters of the Bankruptcy Code.

Chapter 1 contains general provisions including definitions, rules of construction, applicability of chapters and who may be a debtor. The definitions of various terms utilized in the Bankruptcy Code, found in 101, are extremely important. For example, the definition of "person" includes individuals, partnerships, corporations and, in certain enumerated circumstances, a governmental unit. The term "corporation" includes entities normally not thought of as corporations, including unincorporated companies or associations. Section 105 is an "all writs" provision that gives the Bankruptcy Court extremely broad power to carry out the purposes and intent of the Bankruptcy Code, and is the source of the Bankruptcy Court's authority to grant injunctions and other equitable relief.

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Chapter 1 also establishes criteria for who may be a debtor under each chapter of the Bankruptcy Code. For example, railroads may not be Chapter 7 debtors, and insured banks, insurance companies and specified small business investment companies may not be Chapter 7 or Chapter 11 debtors. Only family farmers with regular annual income and individual, corporate or certain partnerships owing less than $1.5 million may file under Chapter 12. Only an individual with regular income that owes non-contingent, liquidated, unsecured debts of less than $250,000 and noncontingent, liquidated, secured debts of less than $750,000 may be a debtor under Chapter 13; while couples may file joint Chapter 13 cases, these debt limits remain the same. While too much debt makes a debtor ineligible for Chapter 13, insolvency is not a condition precedent to any form of voluntary bankruptcy. A municipality may be a debtor under Chapter 9, only if it meets five specific prerequisites. Section 109 provides that no individual may be a debtor who was a debtor at any time in the preceding 180 days if his or her case was dismissed under certain circumstances. These conditions, detailed in Chapter 1, help determine the type of bankruptcy that may be filed.

Chapter 1 also creates standards and penalties pertaining to bankruptcy petition preparers.

Chapter 3

This chapter is entitled "Case Administration" and contains the provisions dealing with how cases are to be handled once filed under the Bankruptcy Code. Significant areas covered include the commencement of the case, the officers (trustees, examiners and other professionals) administration, administrative powers (including the automatic stay, sale, use or lease of property, obtaining credit in executory contracts) and related provisions. The provisions of Chapter 3 apply to all chapters of the Bankruptcy Code.

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The filing of a bankruptcy petition, whether voluntary or involuntary, invokes an *automatic stay*, preventing essentially all actions against the debtor or property of the estate. The stay, provided by 362(a), is automatic and self-executing from the time of filing, not from the time that a creditor receives notice of the bankruptcy. No court order is required. The bankruptcy filing is notice to the world, and the stay is not dependent upon actual notice to any person. The automatic stay casts a mantle of protection over the debtor and the bankruptcy estate, and is, perhaps, the most important benefit provided to a debtor. The bankruptcy estate is defined broadly to consist of all of the debtor's property that exists at the date of the filing of the bankruptcy case plus additional property that may be recovered pursuant to the provisions of the Bankruptcy Code. The automatic stay prevents chaos among creditors seeking repayment upon the initiation of a bankruptcy case and is an effort to strike a compromise between the rights of affected parties debtor to rehabilitate or liquidate in an orderly manner. Complementing the stay are procedures to protect secured creditors whose collateral is utilized by the debtor during the bankruptcy case and provisions enabling the debtor or trustee to obtain financing on a going-forward basis.

The automatic stay affects actions directed at collecting pre-bankruptcy debts against the debtor or the bankruptcy estate. It does not, however, prohibit actions brought by the debtor or trustee. The automatic stay is applicable to party litigants, prosecutors and other parties to court and, in some Stances, administrative proceedings. The automatic stay primarily stays actions to recover pre-petition claims. Typically, actions to recover post-petition claims are only stayed to the extent that a creditor attempts to execute its claim against property of the estate.

Several exceptions exist to the stay provided by the Bankruptcy Code, including the commencement or continuation of a criminal proceeding against the debtor or an action by a governmental unit to enforce its police or regulatory power for the health, safety and welfare of the community, or to establish paternity, or to establish or modify an order for alimony, maintenance or support, or to collect alimony, maintenance or support from property that is not property of the estate. Another important limitation of the stay is that it does not generally protect co-debtors from collection efforts, unless the case is filed under Chapter 12 or 13.

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The stay continues in effect with respect to acts against property of the estate until it is either affirmatively lifted by the court or until the property is no longer in the estate. Property is no longer property of the estate if it is abandoned by the trustee, sold, provided to the debtor as exempt or otherwise disposed. The stay also ends when either the case is closed, the case is dismissed or a discharge is granted or denied. Termination of the stay, however, does not necessarily mean that the debtor is no longer protected. When a discharge is granted to a Chapter 7 individual debtor, for example, it operates as an injunction prohibiting certain collection actions against the debtor.

The automatic stay may be terminated, annulled, modified or conditioned by court order on the motion of a party in interest after notice and a hearing. The court may take such action if it finds "cause," including a lack of *adequate protection*.(see footnote 9)

The principle of adequate protection applies only to an entity that has an interest in property of the estate, such as a secured creditor or a landlord. Adequate protection is the concept that insures that such interest in property is not diminished during the (sometimes lengthy) bankruptcy process. Adequate protection is illustrated but not defined by 361 of the Bankruptcy Code and can be established in any one of three forms:

(1) providing periodic cash payments to protect against any decrease in value that may result from the stay;
(2) providing an additional replacement lien; or
(3) granting such other protection as will provide the protected creditor with the "indubitable equivalent" of its interest.

Lack of adequate protection usually is alleged by secured creditors to claim that their interest in their collateral is at risk. Often, the value of the collateral is deteriorating or being dissipated during the course of a bankruptcy case. Secured creditors, by virtue of due process concerns, are constitutionally entitled to the "indubitable equivalent" of their interest, if their interest has value.

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A lien creditor also can obtain relief from the stay if the debtor does not have any equity in the encumbered property and the property is not necessary to an effective reorganization.(see footnote 10) The creditor has the burden of proof on the issue of whether the debtor has any equity in the property. The debtor or trustee has the burden on all other issues.

The debtor-in-possession's ability to conduct its business and successfully reorganize often will depend upon its ability to use "*cash collateral*." "Cash collateral" includes the debtor's cash, deposits and the like in which a creditor has an interest, and includes proceeds, products, offspring, rents or profits of property and the fees, charges, accounts or other payments for rooms in hotels and the like. In contrast to the Code's liberal authorization of the debtor's conduct of its business in other respects, the debtor-in-possession or trustee is prohibited from using, selling or leasing cash collateral unless (i) each entity that has an interest in the cash collateral consents to such use or disposition, or (ii) the court, after notice and a hearing, authorizes such use, sale or lease.(see footnote 11) The Code also imposes a duty upon the debtor-in-possession or trustee to segregate and account for any cash collateral.(see footnote 12)

The most common example of cash collateral is the debtor's accounts receivable subject to a security interest. In such a case, the monies collected from the accounts constitute cash collateral and cannot be used without the secured creditor's consent or court authorization.

If the debtor continues to use cash collateral without the secured creditor's consent or court approval, the secured creditor may protect its interest in the collateral by initiating litigation in the bankruptcy court such as filing a motion for adequate protection accompanied by a motion for a temporary restraining order.

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The consequences of court denial of a request to use cash collateral could be fatal to the debtor's reorganization efforts. To avoid that risk, where feasible, debtors generally first attempt to obtain the secured creditor's consent to the use of cash collateral before resorting to the court for contested relief.

Absent the secured creditor's consent, the debtor-in-possession must file a motion requesting the court to authorize the use of cash collateral. Such a motion is urgent and often requires the immediate consideration of the court. The Code recognizes this fact and expressly provides that any hearing on the use of cash collateral "shall be scheduled in accordance with the needs of the debtor" for such relief(see footnote 13) and that the court "shall act promptly" on any such request. In exceptional circumstances, if there is not enough time for an actual hearing with proper notice, the court may authorize the use of cash collateral on an *ex parte* request.

In determining whether to authorize a debtor-in-possession to use cash collateral, the court should consider whether the secured creditor's interest in the debtor's property will be adequately protected. If the creditor's interest would be adequately protected under appropriate restrictions and conditions, the court may limit the debtor-in-possession's use of cash collateral by such restrictions and conditions.

The Bankruptcy Code gives the trustee the ability to assume, assign or reject *executory contracts and unexpired leases* subject to Bankruptcy Court approval. The terms "executory contract" and "unexpired lease" are not defined in the Bankruptcy Code. The generally accepted definition of an executory contract is a contract under which the obligations of both the debtor and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other. A contract or lease that has fully terminated prior to the filing of the bankruptcy petition or a contract under which performance remains due by only one party (such as payment) is not assumable or assignable. The question of whether a contract or lease is fully terminated pre-petition is to be determined according to state law.

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Section 365 of the Bankruptcy Code provides detailed rules for determining the rights of the debtor, creditors and other parties with respect to executory contracts and unexpired leases, determining when such contracts and leases can be assumed and/or assigned by the debtor or trustee and providing protections for non-debtor contracting parties.

Chapter 5

This chapter is entitled "Creditors, the Debtor and the Estate" and covers such areas as creditors and claims, the duties and benefits of a debtor, and the estate. Significant areas include all of the avoidance powers of the officers, as well as priorities in payment, exemptions and exceptions to discharge. The provisions of Chapter 5 apply to all chapters of the Bankruptcy Code.

Section 507 governs *priorities* among creditors and delineates how the debtor's estate, once amassed, will be distributed to creditors.

An individual (as opposed to a corporate) debtor is allowed to exempt certain property from his or her bankruptcy estate in accordance with 522. Property exempted is not liable for any debt that arose before the bankruptcy case was commenced except debts excepted from discharge and debts secured by liens that are not avoidable. The Bankruptcy Code provides in 522 a list of federal *exemptions* that a debtor may choose to claim unless the law of the debtor's state prohibits the use of such federal exemptions. In that case, the debtor can rely only on the exemption scheme of that state.

Section 523 sets forth *debts that are not discharged* for an individual debtor under Chapter 7, 11 and 12 (as distinguished from 727, which bars the entire discharge of the Chapter 7 debtor under certain circumstances). Section 524 contains provisions enjoining third parties from interfering with the discharge of a debtor. Modeled after the trust/injunction in the *Johns-Manville* case,(see footnote 14) 524 also permits the Bankruptcy Court to issue an injunction when a trust is established to pay future personal injury claims against the debtor based on exposure to asbestos-containing products.

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With the exception of a municipal bankruptcy under Chapter 9, the filing of a petition for relief under the Bankruptcy Code creates an estate. Section 541 of the Bankruptcy Code specifies what becomes *property of the debtor's estate.* The concept of property of the estate is broad in scope, encompassing all kinds of property, including tangible and intangible property, causes of action, real and personal property, the legal interest of the debtor in property held by the debtor in trust for others, and property of the debtor held by others. Property of the estate also includes certain after-acquired property and certain property that the debtor-in-possession or trustee can recover pursuant to the avoidance powers and provisions of the Bankruptcy Code.

In a Chapter 7 case, property of the estate is collected by the bankruptcy trustee and sold. The proceeds of the sale are then distributed to creditors. In a Chapter 11, 12 or 13 case, the debtor retains the property. The value of this retained property determines the minimum amount that must be offered to non-assenting general creditors in a reorganization plan.

Property acquired after the petition of the estate, with certain exceptions, such as property acquired within 180 days after the filing of a pension by devise, bequest, inheritance, property settlement, agreement or as the beneficiary of a life insurance policy.

Although 541 provides that any interest in property that the estate acquires after the commencement of the case becomes property of the estate, it is important to note that post-petition earnings of an individual debtor in Chapter 7 or Chapter 11 do not become property of the estate.

Section 542 generally requires third parties to turn over property of the estate to the trustee or debtor-in-possession. Sections 544 through 549 grant to the trustee or debtor-in-possession certain powers to bring additional property into the estate by avoiding liens or transfers (voluntary or involuntary) of property of the debtor or obligations incurred by the debtor. Section 544 grants to the trustee or debtor-in-possession the rights of a judgment lien creditor with respect to personal property, and the rights of a bona fide purchaser with respect to real property. This permits the debtor-in-possession or trustee to avoid certain unperfected liens on such property. In addition, 544 allows the trustee or debtor-in-possession to utilize certain state law avoiding powers, including state fraudulent transfer statutes. Preferences and fraudulent transfers are covered by 547 and 548 respectively.

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Property may be abandoned under 554 if it has no value to the bankruptcy estate, if it is encumbered beyond its value, or if the retention of the property would be burdensome to the estate.

The Bankruptcy Code empowers a trustee (debtor-in-possession in Chapter 11 and debtor in Chapter 9) to recover or avoid certain transfers made or obligations incurred by a debtor within specified time periods prior to the filing of the debtor's bankruptcy petition. Unauthorized post-petition transfers also can be avoided. These powers granted to trustees or debtors-in-possession are generally referred to as "*avoidance powers*."

The most commonly used avoidance powers are those concerning preferential transfers contained in 547 of the Bankruptcy Code and those concerning fraudulent transfers contained in 548 of the Bankruptcy Code. Using the avoidance powers, the trustee can analyze retroactively the pre-bankruptcy activity of the debtor. If the debtor made transfers, incurred obligations or otherwise took actions inconsistent with the principle of equality of distribution, then the trustee may be able to unwind or otherwise set aside the transfer or to obtain compensation from the person who received the transfer or who benefited from it.

There are two general purposes for the avoidance powers. First, the avoidance powers discourage creditors from coercing payment of claims in the course of the debtor's slide into bankruptcy. Second, these provisions ensure equal distribution among all creditors of equal standing, the theoretical thrust of the Bankruptcy Code. Obviously, a creditor who is able to squeeze payment from a debtor shortly before the filing of a bankruptcy petition enjoys "preferential" treatment on his claim to the detriment of all other creditors in a comparable position. Similarly, a payment or advantage obtained by some fraudulent means, whether that fraud is "actual" or "constructive," may operate to provide a certain creditor with an unfair advantage.

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Although common law does not condemn preferences, a *preferential transfer* generally is contrary to the rule of bankruptcy providing for equal distribution among all creditors of the same type. A fraudulent transfer generally goes beyond this rule and involves a personal advantage secured by one creditor by means deemed actionable under state or federal law. Both kinds of transfers are subject to bankruptcy scrutiny and, if avoidable, give rise to recoveries for the benefit of all creditors.

For a transfer to be avoided as preferential, it must be a transfer of the debtor's property, or an interest in the debtor's property, to or for the benefit of a creditor on account of an antecedent debt made at a time when the debtor was insolvent, with the result that the creditor receiving the transfer received more than it would receive in a Chapter 7 liquidation case if the payment had not been made. The transfer must have occurred within 90 days before the filing of the bankruptcy petition unless the transfer is to or for the benefit of an insider, in which case the preference period is extended to within one year before the filing of the bankruptcy pension. There are several statutory exceptions to the recovery of a preferential transfer including a transfer that is a contemporaneous exchange for new value or one made in the ordinary course of business of the parties and the industry of the transferor and transferee.

Two general categories of transfers are deemed fraudulent under the Bankruptcy Code and, thus, are avoidable if made within one year of the filing of the bankruptcy petition. Section 548 of the Bankruptcy Code provides for avoidance of transfers (1) undertaken with actual intent to hinder, delay or defraud creditors, and (2) in which the debtor receives less than reasonably equivalent value as consideration for the transfer at a time when the debtor is insolvent, does not possess adequate working capital to carry on its business, or is unable or prospectively unable to pay its debts as those debts become due. State fraud laws contain similar provisions but generally have a longer statute of limitations than the one-year reachback of the Bankruptcy Code. These *fraudulent transfer* laws recently have been applied to so-called leveraged buyouts and also may be applicable to foreclosure actions. Using 544(b) of the Bankruptcy Code, the trustee may avoid fraudulent transfers in accordance with applicable state law to supplement the avoiding power of 548.

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Chapter 7

This is the "liquidation" chapter. Individuals, partnerships and corporations may file for relief under this chapter, and involuntary pensions may also be against them. Cases which proceed under Chapter 7 are intended to more towards a prompt liquidation of all non-exempt assets(see footnote 15) for ultimate distribution to creditors in accordance with priorities established in Chapter 5. Particular issues dealing with the Chapter 7 estate, discharge and treatment of certain claims are unique to this chapter. The provisions in this chapter apply only to Chapter 7 cases.

There are several alternatives to Chapter 7 relief Debtors who are engaged in business, including corporations, partnerships and sole proprietorships, may wish to remain in business and avoid liquidation. Such debtors may consider a petition under Chapter 11 of the Bankruptcy Code. Individual debtors who have a regular income and sole proprietorships also may be eligible for relief under Chapter 13 where an adjustment of debts is sought. In fact, a number of courts have dismissed a Chapter 7 case for substantial abuse when the debtor has the ability to propose and fund a Chapter 13 reorganization plan. Finally, debtors should be aware that out-of-court agreements with creditors or debt counseling services may provide an alternative to a bankruptcy filing.

Chapter 7 envisions the bankruptcy trustees gathering the debtor's non-exempt assets. The individual debtor is permitted to retain certain exempt property, while the debtor's remaining assets are liquidated by a trustee and the proceeds from the sale are distributed according to priorities set by the Bankruptcy Code. Relief is available under Chapter 7 regardless of the amount of the debtor's debts, or whether the debtor is solvent or insolvent.

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One of the primary purposes of bankruptcy is discharging debts to give an honest individual debtor a "fresh financial start." The discharge has the effect of extinguishing the debtor's personal liability on dischargeable debts. In Chapter 7, a discharge is available to individual debtors only. It should be noted that although the filing of an individual chapter 7 pension usually results in a discharge, an individual's right to a discharge is not absolute. In addition, a bankruptcy discharge does not extinguish a lien on property.

A Chapter 7 case begins with the *filing of a petition* with the Bankruptcy Court in the district of the debtor's residence or principal place of business. The debtor also is required to file schedules of assets (including a schedule of exempt property) and liabilities, a schedule of current income and expenditures, a statement of financial affairs and a schedule of executory contracts. The debtor will need to compile a list of all creditors and the amount and nature of their claims; the source, amount and frequency of the debtor's income; a list of all of the debtor's property; and, a detailed list of the debtor's monthly living expenses.

Upon the filing of the Chapter 7 petition, a *trustee* is appointed by the U.S. Trustee (or the court in Alabama and North Carolina) to administer the case and liquidate the debtor's non-exempt assets. Typically, most Chapter 7 cases involving individual debtors are "no asset" cases with no distribution to unsecured creditors. If the case appears to be an asset case, creditors who receive notice of the filing from the court must file a claim within 90 days after the first date set for the meeting of creditors.

The primary role of the trustee in a Chapter 7 "asset" case is to liquidate the debtor's non-exempt assets in a way that maximizes the return to the debtor's unsecured creditors. This is generally accomplished through liquidation of non-exempt property and pursuit of causes of action on claims belonging to the debtor and the trustee's own causes of action to recover money or property under the trustee's "avoiding powers."

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As noted previously, a "*meeting of creditors*" is conducted pursuant to 341(a) of the Bankruptcy Code, and usually is held 20 to 40 days after the pension is filed. The debtor must attend this meeting where creditors may appear and ask questions regarding the debtor's financial affairs and property. The trustee generally conducts this meeting.

The distribution of the property of the estate is governed by 726 of the Bankruptcy Code, which sets forth the order of payment of all claims. There are six classes of claims, and each class must be paid in full before the next lower class is paid anything.

The bankruptcy law regarding the scope of a Chapter 7 *discharge* is complex. Generally, with the exclusion of cases dismissed or converted, individual debtors are discharged from further debt obligations in more than 99 percent of Chapter 7 cases. In most cases, the discharge will be granted relatively early on, that is, 60 to 90 days after the first "meeting of the creditors."

The grounds for denying an individual debtor a discharge in a Chapter 7 case are limited. Among the grounds for denying a discharge are failure to keep or produce adequate books or financial records; failure to explain any loss of assets; commission of a bankruptcy crime such as perjury; failure to obey a lawful order of the Bankruptcy Court; or fraudulent transfer, concealment or destruction of property that would have become property of the estate. In addition to the denial of a general discharge of the debtor, certain debts are non-dischargeable. Among the types of debts that are not discharged in a Chapter 7 case are alimony and support obligations, certain taxes, debts for educational loans made or guaranteed by a governmental unit, debts for death or personal injury caused by the debtor's operation of a motor vehicle while the debtor was intoxicated from alcohol or other substances, certain debts incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement or court decree, consumer debts for luxury goods or services, and fees becoming due post-petition to condominiums, cooperatives are found in 523.

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The court may revoke a Chapter 7 discharge on the request of the trustee, a creditor or the U.S. Trustee if the discharge was obtained through fraud by the debtor. Depending on circumstances, a debtor wishing to keep possession of pledged property, such as an automobile, may find it advantageous to retain the property by paying the secured creditor the amount of its allowed secured claim. Subject to the 523 exceptions listed above and absent any challenge to discharge under 727, the individual debtor will emerge from bankruptcy free of his pre-petition debts. In certain circumstances, however, a debtor may wish to *reaffirm* a debt or debts owed to a creditor that, for example, he wishes to deal with in the future. If the debtor elects to reaffirm the debt, the reaffirmation should be accomplished prior to the granting of the discharge by a written agreement filed with the court. The debtor may repay any debt voluntarily, whether or not a reaffirmation agreement exists.

Chapter 9

This chapter is entitled "Adjustment of Debts of a Municipality," and covers any cases involving any type of municipality that must seek protection under the Bankruptcy Code. Its substantive provisions are very unique to this chapter, although many of the general principles contained in the Bankruptcy Code apply. The provisions in this chapter apply only to Chapter 9 cases.

Prior to 1933, there was no federal or state legislation governing municipal bankruptcies. The lack of legislation resulted from the inability of the federal government to violate the sovereignty of the states and, at the same fame, the constitutional prohibition against states impairing the obligation of contracts. In fact, the first attempt by the federal government to create a municipal bankruptcy law was struck down as unconstitutional by the United States Supreme Court. Since that time, however, Congress has been successful in creating a legislative scheme that passes constitutional muster. The present day statute, while somewhat limited in its jurisdictional grasp, strikes a balance between federal power and state sovereignty. The 1991 filing by the City of Bridgeport, Conn., and the more recent financial problems of Orange County, Calif., have focused attention on Chapter 9.

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Chapter 9 is available to those municipalities (i.e., any political subdivision, public agency or instrumentality of a state) that meet certain requirements. These requirements, in pertinent part, include that the entity must:
(1) be a municipality;
(2) be specifically authorized by the state or state law to file for bankruptcy relief;
(3) be insolvent;
(4) desire to propose and effect a plan to adjust its debts; and
(5) have either negotiated its creditors, attempted to do so unsuccessfully, or shown that attempts to negotiate with its creditors would be impracticable.

The Chapter 9 case is commenced by filing a voluntary pension alleging that the five requirements have been met. A Chapter 9 case cannot be commenced through an involuntary proceeding. Unlike the other chapters, there is no bankruptcy estate created by the filing. The municipality retains total control of its property, revenues and the use or enjoyment of any income-producing property. In no situation may a trustee or examiner be appointed. Further, the Bankruptcy Court does not have any power over the municipality's property and may not interfere with the municipality's political or governmental powers. In other words, with the exception of working out a plan of adjustment, the municipality proceeds with "business as usual." Finally, in order to avoid the infringement of a state's right to control its instrumentalities, the bankruptcy proceeding may not limit or impair this control by the state.

Chapter 9 supplements the protection afforded by the automatic stay of 362(a). The Chapter 9 stay extends to any officer or inhabitant of the municipality in any action seeking to enforce a claim against the municipality. It further precludes the enforcement of a lien on or arising out of taxes or assessments owed to the municipality.

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The municipality has the exclusive right to file *a plan of adjustment*. There is no time limit for filing a plan; however, the Bankruptcy Court may fix a date by which the plan must be filed. Certain provisions of Chapter 11 controlling the contents of plans and the treatment of claims apply to the formulation of Chapter 9 plans. The provisions adopted by Chapter 9 leave the municipality a large amount of discretion in how it proposes to adjust its debts, including whether and to what extent such claims are to be discharged.

Chapter 11

This is the "Reorganization" chapter, the one most usually highlighted in media reports. It is available for individuals, partnerships and corporations, both on a voluntary and involuntary basis. The intent of the chapter is to provide a mechanism whereby business debtors may financially reorganize and propose a plan of reorganization to creditors which provides a greater return than would a liquidation. Many of the provisions become quite complicated because of the unusual issues that are created in the reorganization process. The provisions in this chapter apply only to Chapter 11 cases.

Chapter 11 generally allows the debtor to continue its business operations as it proceeds to the desired goal of a confirmed Plan of Reorganization, which must meet certain statutory criteria. A major rationale for business reorganizations is that the value of a business as an ongoing concern is greater than it would be if its assets were liquidated and sold. Generally, it is more economically efficient reorganize than to liquidate, because doing so preserves jobs and assets. Cooperation among the various interests, however, is crucial to a successful reorganization.

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Chapter 11 may be commenced by the filing of a voluntary pension by the debtor, or the filing of an involuntary petition by creditors that meets certain statutory requirements. As with cases under other chapters, a stay of creditor actions against the debtor automatically goes into effect when the bankruptcy petition (whether voluntary or involuntary) is filed. The automatic stay provides a breathing spell for the debtor during which negotiations can take place to try to resolve the difficulties in the debtor's financial situation and propose a reorganization plan.

Upon filing of a voluntary pension for relief under Chapter 11 (or, in an involuntary case under this chapter, the entry of an order for such relief) the debtor automatically assumes a new identity as the "*debtor-in-possession*." This term refers to a debtor that keeps possession and control of its assets while undergoing a reorganization under Chapter 11, without the appointment of a case trustee, prior to confirmation of a Chapter 11 plan. The appointment of a trustee occurs only in a small percentage of Chapter 11 cases where cause (e.g., fraud, mismanagement or in the interests of creditors) has been established.

The debtor-in-possession's duties include accounting for property, examining and objecting to claims, and filing monthly operating and other reports as required by the court and the U.S. Trustee. The U.S. Trustee is responsible for monitoring the debtor-in-possession's compliance with these reporting requirements. The debtor-in-possession also has many other powers including the right, with the court's approval, to employ attorneys, accountants, appraisers, auctioneers or other professional persons.

In most Chapter 11 cases, the debtor has hundreds if not thousands of creditors, making it impractical for the debtor to try to negotiate with all of them. Thus, *creditors' committees* can play a major role in Chapter 11 cases. The U.S. Trustee appoints the committee, which ordinarily consists of the persons who hold the seven largest unsecured claims against the debtor. The committee may consult with the debtor-in-possession on the administration of the case, investigate the conduct of the debtor and the operation of the business, and participate in the formulation of a plan. A creditors' committee can be an important safeguard to and watchdog over the management of the business by the debtor-in-possession.

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There is no specific statutory time limit set for the filing of a plan; however, the debtor has a 120-day period during which it has an exclusive right to file a plan and a 180-day period to solicit acceptance of the plan. The *exclusivity period* may be extended (and frequently is) or shortened by the court for "cause." After the exclusive period has expired, a creditor or any other party in interest may file a competing plan. The U.S. Trustee, however, may not file a plan.

Although preparation, confirmation and implementation of a plan of reorganization are at the heart of a Chapter 11 case, the debtor often will require funds to operate its business during the case. Indeed, this is one of the first problems facing a Chapter 11 debtor.

When a Chapter 11 debtor needs operating funds, use of cash collateral may be insufficient. *Post-petition financing* may be obtained from a lender by giving the lender a court-approved super-priority administrative claim with priority over other unsecured creditors, by giving the lender a lien on unencumbered assets and/or by granting the lender a palming lien on encumbered assets.

The *U.S. Trustee* plays a major role in monitoring the progress of a Chapter 11 case and supervising its administration. The U.S. Trustee is responsible for monitoring the debtor-in-possession's operation of its business, the submission of operating reports and fees, applications for compensation and reimbursement, plans and disclosure statement and creditors' committees. The U.S. Trustee also conducts the meeting of creditors in a Chapter 11 case, and appoints the official committee of unsecured creditors (and any other appropriate committee) for each case.
Frequently, the debtor-in-possession will initiate a lawsuit, known as an *adversary proceeding*, to recover money or property for the estate. Adversary proceedings also may take the form of lien avoidance actions, actions to avoid preferences, actions to avoid fraudulent transfers or actions to avoid post-petition transfers. Creditors also may file adversary proceedings such as complaints to determine the priority of a lien, to revoke an order of confirmation of a plan, to determine the dischargeability of a debt, to obtain an injunction or to subordinate a claim of another creditor.

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A claim is a right to payment or a right to an equitable remedy for a failure of performance. If a claim is not listed by the debtor in its schedules and statements as disputed, contingent or unliquidated and the creditor agrees with the amount of his claim as listed, then the creditor need not file a *proof of claim* in a Chapter 11 case. It is the responsibility of the creditor to determine whether its claim is accurately listed by the debtor in its schedule of liabilities. In all other instances, a claim needs to be filed; an Official Form has been created for this purpose. The debtor must provide notification to those creditors whose names are added and whose claims are listed as a result of an amendment to the schedules. An equity security holder the holder of an equity interest in the debtor files a proof of interest, rather than a proof of claim.

The court may *convert or dismiss* a Chapter 11 case upon the request of a party for "cause" when there is a continuing to effectuate a plan, unreasonable delay that is prejudicial to creditors, denial or revocation of confirmation, or inability to consummate a confirmed plan. A debtor in a case under Chapter 11 has a one-time absolute right to convert the Chapter 11 case to a Chapter 7 case, unless: (1) the debtor is not a debtor-in-possession; (2) the case originally was commenced as an involuntary case under Chapter 11; or (3) the case was converted to a case under Chapter 11 other than at the debtor's request. A debtor in a Chapter 11 case does not have an absolute right to have the case dismissed upon request.

During the first 120 days after the filing of the voluntary bankruptcy pension, only the debtor-in-possession may file a *Plan of Reorganization.* The debtor-in-possession has 180 days after the filing of the voluntary pension or, in the case of an involuntary pension, the Order for Relief, to obtain acceptances of the plan. The court may extend or reduce this exclusive period for cause. The exclusive right of the debtor-in-possession to file a plan is lost only if: (1) a trustee has been appointed in the case; (2) the debtor has not filed a plan within the 120-day exclusive period or any extension granted by the court; or (3) the debtor has not filed a plan that has been accepted by each class of claims or interests that is impaired under the plan within the 180-day period or any extensions granted by the court.

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If the exclusive period expires, other parties in interest in the case, such as the creditors' committee or any creditor, may file a plan. Liquidating plans are permissible.

Acceptance or rejection of the plan cannot be solicited without prior court approval of a written disclosure statement The disclosure statement must provide "adequate information" sufficient to enable the holder of a claim or interest to make an informed judgment about the plan. After the disclosure statement has been approved, the following items must be mailed to the U.S. Trustee and all creditors and equity security holders: (1) the plan, or a court approved summary of the plan; (2) the disclosure statement approved by the court; (3) notice of the time within which acceptances and rejections of the plan may be filed; and, (4) such other information as the court may direct, including any opinion of the court approving the disclosure statement or a court approved summary of the opinion.

Section 1123(a) of the Bankruptcy Code lists the mandatory contents of a plan, and 1123(b) lists the discretionary provisions. Section 1123(a)(1) provides that a Chapter 11 plan shall designate classes of claims and interests for treatment under the proposed reorganization. Generally, a plan will classify claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors and equity security holders.

When competing plans are presented and meet the requirements for confirmation, the court must consider the preferences of the creditors and equity security holders in determining which plan to confirm. Any party in interest may file an objection requires the court, after notice, to hold a hearing on confirmation of a plan. For confirmation to be granted, the court must find that (1) the plan is feasible, (2) that it is proposed in good faith and (3) that the plan and the proponent of the plan are in compliance with the Bankruptcy Code. In addition, the court must find that confirmation of the plan is not likely to be followed by liquidation or the need for further financial reorganization.

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After the plan is confirmed, the debtor is required to make plan payments and is bound by the provisions of the plan of reorganization. The confirmed plan, or discharge creates new contractual rights, replacing or superseding pre-bankruptcy contracts. Recent amendments require the Chapter 11 debtor to continue to make quarterly fee payments to the U.S. Trustee post-confirmation, until the case is finally closed.

At any time after confirmation and before "substantial consummation" of a plan, the proponent of a plan may modify a previously confirmed plan. This should be distinguished from pre-confirmation modification of the plan. A modified post-confirmation plan does not automatically become the plan. The court must confirm the plan as modified. A Chapter 11 trustee or debtor-in-possession has a number of responsibilities to perform after confirmation, including consummating the plan, reporting on the status of consummation and applying for a final decree, which closes the case.

A *revocation* of the confirmation order is an undoing or cancellation of the confirmation of the plan. A request for revocation of confirmation, if made at all, must be made by a party in interest within 180 days of confirmation. The court, after notice and a hearing, may revoke a confirmation order "if and only if the confirmation order was procured by fraud."

The *final decree* closing the case should be entered after an estate has been fully administered.

Chapter 12

This chapter is entitled "Adjustment of Debts of a Family Farmer with Regular Income" and was added to the Bankruptcy Code to meet the unique needs of farming operations confronted with financial difficulties. Its provisions follow the concepts contained in Chapter 11 and elsewhere in the Bankruptcy Code, but provide greater flexibility and latitude for the farm debtor than would otherwise be available if the case were in Chapter 11. The term "family farmer" is defined in Section 101(18) and is available to individuals and corporations, where aggregate debts do not exceed $1,500,000 and not less than 80% of the debts arise out of farming operations owned by such debtor. The provisions in this chapter apply only to Chapter 12 cases.

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Chapter 12 of the Bankruptcy Code was enacted by Congress in 1986, specifically to meet the needs of financially distressed family farmers. A Chapter 12 filing begins in much the same way as other bankruptcies with the filing of a pension additional forms, schedules, financial statements and a Chapter 12 statement. Upon filing of the petition, the automatic stay goes into effect. As with all other types of bankruptcy, approximately 20 to 40 days after the pension is filed, a 341 meeting of creditors is held. The debtor must attend the meeting, where creditors and the trustee appear and ask questions of the debtor.

The debtor must file a plan of repayment with the petition or within 90 days thereafter, unless the court determines that an extension is justified. Plans, which must be approved by the court, provide for payments of fixed amounts to the trustee on a regular basis. The trustee then distributes the funds to creditors according to the terms of the plan. As in Chapter 13, the debtor's plan usually lasts three to five years. It must provide for payment in full to all priority creditors. Unsecured creditors do not have to be paid in full, as long as the debtor pays under the plan all projected "disposable income" over the three to five years that the plan is in effect, and unsecured creditors receive at least as much as they would receive if the debtor's non-exempt assets were liquidated in Chapter 7. Disposable income is defined as income that is not reasonably necessary for the maintenance or support of the debtor or his/her dependents, or for payment of expenditures necessary for the confirmation, preservation and operation of the debtor's business. Secured creditors must be paid at least as much as the value of the collateral pledged for the debt. One feature of Chapter 12 is that, in certain circumstances, payments to secured creditors can continue longer than the five-year period during which the plan provides payment to unsecured and priority creditors.

Within 45 days after the filing of the plan, the Bankruptcy Judge must determine whether the plan is feasible and satisfies all requirements for confirmation at a "confirmation hearing." Creditors may attend this hearing and object to the plan or any part of the plan. Once the plan is confirmed by the Bankruptcy Judge, the trustee commences distribution of the funds received from the debtor. The Chapter 12 trustee keeps a percentage of these distributions as compensation for work performed. If the plan is not confirmed, the funds paid to the trustee are returned to the debtor after deduction of the trustee's fee. Once the court confirms the plan, it is incumbent upon the debtor to make the plan succeed. The debtor must make regular payments to the trustee. During the period of the plan, the debtor should not incur any significant credit obligations without consulting the trustee.

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As is the case under Chapter 13, upon successful completion of all payments under the confirmed plan, the debtor will receive a "discharge" that extinguishes the debtor's obligations to pay any unsecured debts that were included in the plan, even though they may not have been paid in full. After the discharge has been granted, those creditors whose claims were provided for in full or in part under the plan no longer may initiate or continue any legal or other action against the debtor to collect the discharged obligations. there are certain categories of debts that are not discharged. In the event that there exist circumstances for which the family farmer "should not justly be held accountable," and if other statutory criteria are met, a family farmer may be excused from completing payments under a Plan of Reorganization. If the court finds that such circumstances exist along with other criteria, the judge may award the debtor a "hardship" discharge of all unsecured debts. Injury or illness that precludes employment sufficient to fund even a modified plan may serve as the basis for a hardship discharge.

Chapter 13

This chapter is entitled "Adjustment of Debts of an Individual with Regular Income" and is available only to individuals with regular income. Additionally, to be eligible, an individual's debts (or those of a husband and wife) may not exceed $750,000 of secured debt and $250,000 of unsecured debt. The provisions in this chapter apply only to Chapter 13 cases.

Chapter 13 is frequently referred to as a "wage earner" chapter, although its benefits and protection are available to individuals with any form of regular income. Chapter 13 is designed for individuals with regular income who desire to pay their debts but currently are unable to do so. The purpose of Chapter 13 is to enable financially distressed individual debtors to propose and carry out a repayment plan under which creditors are paid over an extended period of time under court supervision and protection. Under this chapter, debtors are permitted to repay creditors, in full or in part, in installments over a three-year period, during which time creditors are prohibited from starting or continuing collection efforts.

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A Chapter 13 case begins with the filing of a petition with the Bankruptcy Court serving the area where the debtor lives. In order to complete the Official Bankruptcy Forms that make up the petition, the debtor will need to compile the following information:

1. A list of all creditors, and the amount and nature of the claims;
2. The source, amount and frequency of the debtor's income;
3. A list of all of the debtor's property; and

4. A detailed list of the debtor's monthly living expenses.

Upon the filing of the petition, an impartial trustee is appointed by the court or the U.S. Trustee to administer the case. A primary role of the Chapter 13 trustee is to serve as a disbursing agent, collecting payments from debtors and making distributions to creditors. For this service, the trustee receives 10 percent of all payments made under the plan. The filing of the petition under Chapter 13 automatically stays most actions against the debtor or the debtor's property. Creditors receive notice of the filing of the petition from the Bankruptcy Court Clerk or the trustee. After the commencement of a Chapter 13 case, unless the Bankruptcy Court authorizes otherwise, a creditor may not seek to collect a "consumer debt" from any individual who is liable, as a co-debtor, with the debtor on such debt. A 341 meeting of creditors is held usually within 20 to 40 days after the petition is filed. The debtor must attend this meeting where creditors may appear and ask questions regarding the debtor's financial affairs. The trustee also attends this meeting and questions the debtor on the same matters. Unsecured creditors who have claims against the debtor must file their claims with the court within 90 days after the first date set for the meeting of creditors. An unsecured creditor who fails to file such a claim within that period is barred from doing so later.

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The debtor must file a plan of repayment with the petition, or within 15 days thereafter unless extended by the court for cause. The plan must provide for the full payment of all claims entitled to priority under Bankruptcy Code 507. If the plan classifies claims it must provide the same treatment for each claim within each class; and it must provide for the submission of such portion of the debtor's future income to the supervision of the trustee as is necessary for the execution of the plan. If the trustee or a creditor with an unsecured claim objects to the confirmation of the plan, the debtor is obligated to pay the amount of the claim or commit to the proposed plan all projected "disposable income" during the period in which the plan is in effect typically three to five years. Disposable income is defined as all income in excess of what the debtor requires for the support of the debtor and dependents. Within 30 days after filing of the plan, even if the plan has not yet been confirmed by the court, the debtor must start making payments to the trustee.

The Bankruptcy Judge must determine at a confirmation hearing whether the plan is feasible and meets the standards for confirmation. In Chapter 13, creditors do not vote on the plan, but they can object to confirmation. While a variety of objections may be made, the most frequent is that the present value of payments offered under the plan is less than creditors would receive if the debtor's assets were liquidated in Chapter 7. If the plan is confirmed by the Bankruptcy Judge, it becomes binding on the debtor and all creditors, and the Chapter 13 trustee commences distribution of the funds received. A confirmed plan can be modified if the debtor's financial circumstances change. The debtor also has a right to dismiss the case or convert the case to Chapter 7. Once the court confirms the plan, it is the responsibility of the debtor to make the plan succeed. The debtor must make regular payments to the trustee. The failure to make the payments may result in dismissal of the case or its conversion to a liquidation case under Chapter 7.

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The Chapter 13 debtor is entitled to a *discharge* upon successful completion of all payments under the confirmed Chapter 13 plan. The discharge in Chapter 13 is broader than that available in Chapter 7. The debtor is discharged from all debts provided for by the plan or disallowed except certain long term obligations (e.g., home mortgage debt, provided for in the plan) and other non-dischargeable debts under 523 (e.g., alimony and child support). The debtor will still be responsible for these debts after the bankruptcy case has concluded. After confirmation of a plan, there are limited circumstances under which the debtor may request the court to grant a "hardship discharge" even though the debtor has failed to complete payments. The hardship discharge is a very limited and specific situation with limited implementation.

CONSUMER ISSUES--POSSIBLE AREAS FOR REFORM

Good Faith Filings

Currently, Section 707(b) of the Bankruptcy Code provides that on the motion of the court or the United States Trustee, but not at the request or suggestion of a creditor or other party in interest, the court may dismiss a case filed by an individual whose debts are primarily consumer debts if granting Chapter 7 relief would be a substantial abuse. As noted above, Chapter 13 provides for a periodic payment in installments to creditors, although the payment may not be in full.

Under Chapter 13, an individual debtor provides the Bankruptcy Court with a list of all assets and liabilities as well as a budget. The debtor(s) then proposes a plan to creditors over three years (which may be extended to five years) which provides for the satisfaction of creditors' claims. Secured creditors must continue to be paid if the debtor desires to keep the collateral securing the debt. Unsecured creditors receive a pro rata payment based upon two factors--(1) the ability of the debtor to make payments based upon the budget and (2) the amount that the creditor may obtain in a Chapter 7 liquidation. Provided the plan gives the creditor more than it would in a Chapter 7 liquidation and is a "best effort" of the debtor based upon the budget requirements, the court will usually confirm the plan. The purpose of Chapter 13 is to permit a debtor to keep his or her assets (even if non-exempt), and do the best that can be done to satisfy the claims of creditors.

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In states where exempt assets are substantial (see below), Chapter 13s are less frequently utilized because of the fact that debtors do not need to pay any money to creditors under Chapter 13 as they may retain all of their assets under Chapter 7.

There have been a number of proposals that seek consideration of either a "mandatory" Chapter 13 filing or a greater ability for utilization of Section 707(b).

The discussion raises not only certain constitutional issues, but also issues concerning the social impact of requiring an "objective/subjective" test as a prerequisite for bankruptcy relief.

Exemption of Assets

When the Bankruptcy Code was enacted in 1978 (to be effective October 1, 1979), Congress provided in Section 522 for a series of federal exemptions which an individual debtor could elect to utilize when filing bankruptcy. Exemptions, which are only available to individuals, follow the historic pattern in the United States of permitting debtors to retain certain assets out of the reach of creditors. Until the adoption of the Bankruptcy Code, debtors could only utilize such exemptions as may be available to them in their individual state of residence.

The Bankruptcy Code also provided for an "opt out" provision whereby a state could legislate away the federal exemptions, permitting a debtor to choose the state exemptions if they were more liberal or beneficial than the federal exemptions.

A vast majority (37) of the states have opted out from the federal exemptions, so that in most jurisdictions, debtors choose the state exemptions. Certain states such as Florida and Texas have extremely liberal exemptions, the utilization of which have prompted substantial media coverage as a result of perceptive and actual abuses. Indeed, there are a substantial number of documented cases where individuals move from one state to another in order to enjoy the more liberal exemptions available in another state.

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Consideration will have to be given to the possibility of enacting uniform federal exemptions which will be available to all individuals who seek Bankruptcy Court and Bankruptcy Code protection. A constitutional issue may be raised as to whether Congress may eliminate one's right to utilize state exemptions, but this should not be an impediment to the legislation, since the state exemptions would still be available if the individual chose not to utilize the provisions of the Bankruptcy Code.

If the uniform exemptions are to be considered, the significant issue before Congress will be the extent of such exemptions. Issues will arise with respect to geographic, territorial and lifestyle differences which may question the feasibility of creating a uniform set of exemptions that will provide equal benefit and protection to all individuals seeking Bankruptcy Code protection and relief.

Avoidance of Liens

Section 522 of the Bankruptcy Code also permits an individual debtor to avoid a lien which impairs exempt property. There has been a substantial amount of publicity that such a provision has been abused by creditors in permitting them to scheme to defraud creditors, especially those where personal property is used to secure (collateralize) a loan.

Dischargeability of Debts

Section 523 of the Bankruptcy Code provides that individuals, who are otherwise entitled to a discharge under the provisions of any chapter may have certain debts excluded from discharge--i.e., they survive the bankruptcy.(see footnote 16) Although it has been amended from time to time to become more inclusive of non-dischargeable obligations, the concept of discharge and dischargeability is to create a balance between the rights of debtors to a "fresh start" and the rights of creditors to object to inappropriate acts and conduct on the part of debtors with respect to their individual debts.

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Currently, debts which are non-dischargeable include the following:
Taxes--generally income taxes which are less than three years old where returns have been filed or taxes based upon fraudulent returns.
Money, property, services or an extension of renewal of credit based upon false pretenses, false representations, actual fraud or based upon a false financial statement which is materially false upon which a creditor reasonably relied.
Debts due to a single creditor aggregating more than $1,000 for "luxury goods or services" incurred within 60 days before the bankruptcy or cash advances more than "$1,000" that are extensions of goods or credit obtained within 60 days before the bankruptcy filing.
Debts which are not scheduled in the bankruptcy papers in time for the creditor to take action.
For fraud or defalcation while acting in a fiduciary capacity.
Debts incurred by embezzlement or larceny.
Debts to a spouse, former spouse or child of the debtor for alimony to, maintenance for or support of such spouse or child in connection with a separation agreement, divorce decree or other order of a court of record.
Debts for willful or malicious injury by the debtor to another entity or the property of another entity.
Certain fines, penalties and forfeitures to governmental units.
Debts for educational loans short of guaranteed by a governmental unit less than seven years before their due date.
Debts for death or personal injury caused by the debtor's operation of a motor vehicle, while under the influence of alcohol, drug or other substance intoxication.
Debts based upon an order of restitution issued under Title 18 of the United States Code (the Criminal Code).

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While the above list is perceptively very encompassing, issues have arisen as to whether the non-dischargeable debts as promulgated by Congress should be expanded or curtailed, and whether the existing debts should be expanded or curtailed.

Chapter 13 Eligibility

In 1994, Congress expanded the eligibility for individuals to file a Chapter 13 to include any individual whose secured debts do not exceed $750,000 and whose unsecured debts do not exceed $250,000.(see footnote 17) While many believe that the expansion of the eligibility to file Chapter 13 is beneficial, many others from the creditor community believe that the eligibility should be limited to individuals who receive income from others rather than individuals who are proprietors of business. The 1994 enlargement of eligibility has permitted individuals who are sole proprietors to utilize Chapter 13 for a business reorganization rather than requiring the use of Chapter 11. Since the rights afforded to debtors are much more "generous" in Chapter 13 and the rights afforded to creditors are more limited, a debate has developed as to whether Chapter 13 should be utilized by individuals who are sole proprietors in business as opposed to true "wage earners." The original concept of Chapter 13 in the 1978 Bankruptcy Code was limited to true "wage earners" with there not being the intention that it would be expanded to those who would own and operate businesses.

Concurrently, consideration needs to be given to make Chapter 13 a more attractive alternative to Chapter 7.

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BUSINESS ISSUES--POSSIBLE AREAS FOR REFORM

Small Business Reorganizations

When the Bankruptcy Code was totally revised in 1978, Chapter 11 was created in its present form to permit a business to reorganize, adjust its debts and take the steps necessary to continue to survive in business and effect a financial reorganization. In the form that it was adopted, Chapter 11 was designed for any type of business, small, medium or large. As reorganizations have evolved, there appears to be a consensus of opinion that the structure of Chapter 11 does not accommodate the effective reorganization of a small business. That is not to say that legal principles need to be changed, but, instead, the procedures (with some substance) need to be modified so as to provide for a more expeditious, more cost efficient and more flexible procedure for small businesses to effect their reorganization.

In the last two sessions of Congress, the Senate has passed a Chapter 10, a new reorganization chapter for small businesses. Unfortunately, such passage was effected at the eleventh hour, and the Conference Committees were unable to agree on language to implement this new chapter. In the last session of Congress, a few of the suggested changes were placed into Chapter 11 to try to bring relief for small businesses.

Undoubtedly, changes will need to be made in order to permit small businesses to be able to utilize the reorganization process of the Bankruptcy Code without all of the time and expense requirements of Chapter 11. Various proposals have been submitted as to how best to implement this, with there being no absolute consensus on the single best vehicle to follow.

Some of the areas where changes may be effected are the following:

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Providing for a specific objective determination as to what constitutes a small business.
Providing for the establishment of a creditors' committee only if creditors request one.
Establishing an oversight responsibility of the Office of the U.S. Trustee where no creditors' committee exists.
Shortening time limitations during which the debtor must file a plan and disclosure statement.
Providing for an expeditious method for the court to determine if the case should be dismissed based upon no reasonable expectation of a reorganization.
Permitting debtors to use their "best efforts" to effect a reorganization, even over the objection of creditors.
Permitting shareholders of debtors to retain their stock or partnership interest even if creditors are not satisfied in full.
Streamlining the overall procedure so as to reduce legal fees and expenses.
Giving the Bankruptcy Judge greater oversight authority.

Executory Contracts

An executory contract has been defined as one where there is performance required on both parties so that either may enforce the performance by bringing an action for specific performance. Typical examples involve leases, employment contracts, franchise agreements, collective bargaining agreements and the like.

Under the provisions of Section 365 of the Bankruptcy Code, a debtor may reject an executory contract, with the Bankruptcy Code imposing a statutory limitation on damages which may be claimed by the creditor whose contract has been rejected. Section 1113 has been added to the Bankruptcy Code to impose stringent preconditions and restrictions on debtors agreement. Other provisions have been added to the Bankruptcy Code since its inception to require the assumption or rejection of certain real estate leases and equipment leases within 60 days of the filing of the bankruptcy case. In each instance, in order for a debtor to assume an executory contract, it is required to cure all pre-bankruptcy and post-bankruptcy monetary defaults.

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Because of the substantial litigation that has evolved with respect to the concept of assumption and rejection of executory contracts, as well as the definition of an executory contract, a review of the entirety of the concept may be in order. Questions have been raised as to whether the Bankruptcy Courts should be given statutory authority to exercise greater control over the debtors' decisions to assume or reject executory contracts. Additionally, consideration should be given with respect to the following areas involving executory contracts:
Should Section 365 of the Bankruptcy Code be clarified as to the effect of a rejection of an executory contract?
Pending the debtor's assumption or rejection of an executory contract, what duties should be imposed on a non-debtor party to an executory contract?
Pending assumption or rejection of an executory contract, what duties should be imposed on a debtor who is a party to an executory contract?
Should a non-debtor party to an executory contract have greater rights in order to compel a debtor to more timely make a decision with respect to the assumption or rejection of the executory contract?
Should the limitation of damages arising as a result of the rejection of an executory contract be expanded or curtailed?
Should Congress eliminate subsections of Section 365 that provide for specific rules for particular types of executory contracts, providing that all parties to executory contracts be treated equally?

Preferences

Under Section 547 of the Bankruptcy Code, a transfer of property by a debtor within 90 days of the bankruptcy proceeding's beginning to a creditor which enables the creditor to receive more than it would in a Chapter 7 liquidation may be set aside by the trustee or Chapter 11 debtor-in-possession. The long-standing policy of Congress in this area is to "level the playing field" and, at the same time, to create a disincentive to "rushing to the court house door."

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While these principles are espoused by all constituents in the bankruptcy area, there is a perceptive abuse of the preference procedure by some who would try to effect the repayment of any transfers within 90 days before the bankruptcy, requiring creditors to defend their business practices at great expense.

In 1984, Congress, noting the inequalities that existed, modified the exceptions to preferences to permit a more expansive defense on the part of creditors who purportedly receive preferential transfers.

Various suggestions have been made in order to more appropriately "equalize" the balance between the estate and creditors in the areas of preference. Some of the suggestions that have been made are the following:
Provide that for transfers below a certain threshold (i.e., $3,000) no preference action may be brought.
For transfers at a certain level above the threshold but below a certain ceiling (i.e., above $3,000 but below $10,000), the preference action could only be brought in the creditor's jurisdiction.
Requiring a trustee or debtor-in-possession to meet a threshold test before the Bankruptcy Court to show that there will be a net benefit to the estate in the bringing of the preference actions. This will place the professionals' prospective fees "on the line."
Requiring recoveries made on account of preferential transfers to be distributed on a pro rata basis within the class of creditors from which they are obtained.
Expanding the availability of the ordinary course of business exception for the defense of preferential transfers.

Administrative Monitoring of Cases

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In 1978 and thereafter, the Office of the U.S. Trustee was established in order to relieve the Bankruptcy Judges from any ministerial functions, and to permit them to be solely arbiters of disputed issues. The Office of the U.S. Trustee is under the auspices of the U.S. Justice Department, and performs a statutory function with respect to the monitoring and administration of the bankruptcy system.

There has been criticism of the Office of the U.S. Trustee (as there would be with any bureaucratic function), and the

effectiveness of the Office of the U.S. Trustee must be completely examined. A consideration needs to be given as to whether this function should be moved to the judicial branch, and, if not, if there is a need for statutory modification.
In connection with this discussion, the role of any administrator in the bankruptcy process should be considered, and a determination made as to how best to create a system (if one needs to be created) which will provide the monitoring administration of bankruptcy cases that is perceived to be necessary.

Reclamation
The Uniform Commercial Code provides in Section 2—702 that creditors may reclaim goods that are delivered to a debtor if there is an insolvency within the ten days of delivery. The Bankruptcy Code, for the most part, adopts this principle, and in 1994, Congress even expanded the time during which a notice of reclamation may be provided. However, the Bankruptcy Code provides that the right of reclamation shall be junior to the rights of secured creditors, and shall be limited to a reclamation (or an administrative claim) for goods remaining in the debtor's possession when the notice is given.
This has led to extensive and protracted litigation which is expensive for the creditors, the debtor and the estate. Additionally, because of the priority of the claims of secured creditors, many times there is little or no relief to the reclaiming unsecured creditors.

The current system under the Bankruptcy Code provides no relief for vendors of services who provide services within ten days prior to the bankruptcy. This creates a disparity in possible relief given to different types of creditors. Consideration must be given to what, if any, revisions to the reclamation provisions should be made in order to carry out the intent of the law to foster and create an equality based upon appropriateness of actions.
Single Asset Real Estate Cases
In 1994, Congress enacted provisions which require single asset real estate cases where there is less than a threshold amount of debt to be treated by the Bankruptcy Court in a more expeditious manner, providing additional rights to secured creditors. While most agree that this legislation was needed, there needs to be a review as to how (or if) this exception should be modified.

Plan of Reorganization Formulation
The present Bankruptcy Code provides that during the first 120 days of a bankruptcy case, only the debtor may file a plan of reorganization. Unless this time limitation is extended by the court, after the expiration of the 120 days, any creditor or party in interest may file a plan.
Many courts, especially in larger and more complicated cases, will extend the period of exclusivity for months or years, granting a protracted period of time during which only the debtor may file a plan of reorganization. Consideration should be given as to whether there should be a limitation on how long or how many times a court may extend the period of exclusivity and on what basis.

Mass Torts

Chapter 11 has been utilized by debtors who experience problems involving mass torts such as in the areas of asbestos litigation, breast implant litigation, airplane crashes and the like. Given the fact that there may be upcoming significant cases involving tobacco liability, lead paint liability and other areas of mass torts, Congress should consider whether there needs to be a separate reorganization procedure for debtors who have otherwise healthy businesses but are experiencing mass tort liabilities.
Several years ago, the American Bankruptcy Institute, at the request of this Committee, developed a concept of a new Chapter 14 which would provide for the reorganization of businesses experiencing mass tort liabilities. Given the present climate, it is suggested that it may be appropriate for this Committee to again review such a proposal.

Disinterestedness of Professionals
Debtors, debtors-in-possession, creditors' committees, trustees, and other officers of the estate are authorized by the

Bankruptcy Code to employ professionals to assist the estate and the officers in carrying out the responsibilities and obligations mandated by the Bankruptcy Code. The 1978 adoption of the Bankruptcy Code attempted to create a test of "disinterestedness" to determine when an individual's prior participation with respect to any of the parties in interest involving the debtor was such that the person would be deemed to be not sufficiently disinterested to be able to serve the estate in a fiduciary capacity and as an officer of the court. Congress has since amended these provisions attempting to formulate a more workable definition for disinterestedness.

There appears to be a need for Congress to again review the definition and some basic conceptual issues involving the disinterestedness test. Many have taken the position that the current legislative mandate is not practically workable, and has the effect of frustrating the legislative intent contained throughout the remainder of the Bankruptcy Code.

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Creditors' Committees

Creditors' committees are a valuable tool in the balancing of rights in connection with the administration of Chapter 11 cases. Under the present law, the Office of the United States Trustee appoints the creditors' committee from a list of the largest unsecured creditors of the debtor, as provided on a list filed simultaneously with the commencement of the case. The law does not mandate the composition of the creditors' committee, but states that it should "usually" consist of the seven largest unsecured creditors.

Under the present law, the courts do not have the power to change the composition nor do the courts have the power to review the decisions of the United States Trustee with respect to the inclusion or exclusion of membership on the committee. Given the significance and importance of the creditors' committees, consideration should be given to grant oversight and revisory power to the courts with respect to the creation and composition of the creditors' committees.

Claims Trading

A recent issue has developed with respect to the trading of claims in large Chapter 11 cases, especially those where there is significant public debt and, most time, public stock. Professionals will offer trade and other unsecured creditors lump sum payments to "buy" their claims. Currently, the bankruptcy law does not provide any protection for creditors with respect to the information that is provided to them by those seeking to purchase their claims. It is claimed that creditors (especially smaller creditors) often receive exaggerated "doomsday" assertions or disinformation in an attempt to purchase the claim at a lower price. Consideration should be given as to legislation which would provide controls with respect to the solicitation and trading of claims.

Additionally, when such claims in large amounts have been purchased from members of a creditors' committee, the question arises as to whether the transferee may be substituted as a member of the creditors' committee or should be able to vote on the plan. Since the interest of claims traders are different from those of ongoing trade creditors and governmental agencies who participate as members of a creditors' committee and vote on plans, consideration should be given as to whether such claims traders should be permitted to participate in creditors' committee deliberations and the plan acceptance process.

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ADMINISTRATIVE AND JURISDICTIONAL ISSUES--POSSIBLE AREAS FOR REFORM

Status of Bankruptcy Judges

Currently, Bankruptcy Judges are judges pursuant to Article I of the U.S. Constitution, and they do not possess the power, authority, equality, tenure and other indicia of U.S. District Judges. As a result, based upon a decision by the U.S. Supreme Court, in 1984, Congress established the present system where Bankruptcy Courts and Bankruptcy Judges are part of the U.S. District Court system, with all bankruptcy cases being referred to Bankruptcy Judges by the District Courts.

Consideration should be given as to whether Bankruptcy Judges should be elevated to Article III status. This would create a system which would eliminate current problems involving personal injury, wrongful death, jury trials, appeals, and miscellaneous other jurisdictional problems where the Bankruptcy Courts are part of the District Court. Detailed consideration needs to be given as to which system would more effectively promote the ends of the intent of the Bankruptcy Code.

Bankruptcy Appeals

Currently, except where provided by statute and approved by Circuit Courts of Appeal, bankruptcy appeals first go to the U.S. District Court and then the U.S. Circuit Court of Appeals. In certain circuits, bankruptcy appellate panels have been established to take the place of District Courts to more efficiently and expeditiously deal with bankruptcy appeals. Since the authority to create such bankruptcy appellate panels is left with the various Circuit Courts of Appeal, the appellate process throughout the U.S. is far from uniform.

Consideration should be given as to whether there should be a single uniform appellate process and procedure for bankruptcy appeals. Because of the large criminal case loads of District Court Judges, where bankruptcy appellate panels have not been created, there are inordinately long delays for the bankruptcy appeals to be considered and resolved.

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Venue of Bankruptcy Cases

Currently, the bankruptcy law provides that a bankruptcy case may be commenced where the debtor has its principal place of business, where the debtor has its principal assets, or the place of incorporation of the debtor. As a result of the latter provision, there has been a substantial amount of media attention paid to the large number of cases filed in the Bankruptcy Court in Delaware, many of which are termed to be "prepackaged" bankruptcy cases.

Consideration should be given as to whether the eligibility to file bankruptcy in the place of incorporation of the debtor should be eliminated. The public perception has been created that "prepackaged" and "fast track" cases in Delaware do not, necessarily, provide the same rights and protections for creditors as may be administered elsewhere in the United States. Whether this is actually the case or not may not be of the greatest significance, as this may be a situation where perception is as important as reality.

Virgin Islands Bankruptcy Court Crisis

On March 17, 1997, a District Judge in the United States Courts of the Virgin Islands ruled that the Bankruptcy Courts are improperly constituted in the Virgin Islands and that the Bankruptcy Judges designated to sit by the United States Court of Appeals for the Third Circuit are without power and authority to act. Moreover, the Third Circuit does not have the authority to thus appoint the Bankruptcy Judges.

This opinion (more than 50 pages in length) recites the historical basis of the court system in the Virgin Islands focusing on the fact that the District Judges of the Virgin Islands are appointed pursuant to Article I of the U.S. Constitution and not Article III. In summary, since the judges of the District Court of the Virgin Islands are not "U.S. District Judges," there is no "U.S. District Court" in which bankruptcy cases may be filed, and, therefore, the Third Circuit's appointment of Bankruptcy Judges to sit in the Territory of the Virgin Islands is without basis or authority. Furthermore, since the District Judges in the Virgin Islands are not Article II judges, they may not hear appeals from the Bankruptcy Court, which further frustrates the entire process.

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While the Virgin Islands do not have a large number of bankruptcy filings, there are pending a number of significant business cases which would grind to a halt if this situation is not promptly resolved. Furthermore, should business or consumer debtors need relief, it may be difficult to secure on a timely basis.

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AMERICAN BANKRUPTCY INSTITUTE REPORT ON THE STATE OF THE AMERICAN BANKRUPTCY SYSTEM

ACKNOWLEDGMENTS

I know that I speak for all of the members of the Survey Steering Committee when I say that, when we first

contemplated the Survey and envisioned this Report more than two and one-half years ago, we did not foresee the magnitude of the tactic we were about to undertake, or the nature of the challenges we were to overcome. Therefore, and precisely because of the commitment, intellect and energies of these Committee members, the success of and potential for contribution by the Survey to the improvement of the bankruptcy process has been ensured.

In particular, I note that it would not have been possible for the Survey to have been completed without the untiring assistance, patience, wisdom, pragmatism and remarkable good humor of my "second-in-command," John D. Penn, of Haynes & Boone, LLP, Fort Worth, Texas. Moreover, absent the herculean efforts and consummate professionalism of the Survey's Reporter, Prof. G. Ray Warner, University of Missouri at Kansas City, School of Law, this extraordinarily insightful Survey and analysis of the Survey's results would never have come to fruition.

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The ability to undertake and complete this Survey also required the vision, guidance and unwavering support, financially and otherwise, of the American Bankruptcy Institute, its Executive Committee and its Board of Directors. The Committee also gratefully acknowledges the expertise of and survey research services provided by Louis H. Primavera, Ph.D., and the staff of the Graduate School of Arts and Sciences of St. John's University.

Many thanks go to the various ABI leaders who gave so generously of their time and expertise in the hope (and with the expectation) that the Survey will prove to be an invaluable resource for the National Bankruptcy Review Commission as it continues its deliberations, as well as for the bankruptcy community generally. These leaders include Robert M. Zinman, Robert Fishman, the Honorable Samuel L. Bufford, the Honorable Leif M. Clark, the Honorable Lisa Hill Penning, Susan B. Hersh and M. Freddie Reiss. In addition, Samuel J. Gerdano, Executive Director, and the ABI staff provided never-ending support and encouragement.

On a personal note, I want to acknowledge all of my ABI friends who responded to my calls for assistance and were so unselfish in their contributions to the survey's development and completion. Finally, I would like to offer a special thanks to Marcia L. Steen, of my office, who spent countless hours working with and providing support to me as the survey was transformed from a "mere idea" into today's final report.

Richard M. Meth, *Chair,*
Friedman Siegelbaum,
Roseland, New Jersey.

INTRODUCTION

This report is the capstone of the ABIs three-year Bankruptcy Reform Study Project. The Project was designed to inform the process of bankruptcy reform, which is currently the subject of proceedings before the National Bankruptcy Reform Commission. The ABI Bankruptcy Reform Study Project produced dozens of academic papers and sponsored ten symposia on a wide range of hotly debated bankruptcy issues.

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The Project's efforts culminated this August with a 65-question survey covering a broad spectrum of possible areas of reform. The survey was designed to balance the theoretical approach of the scholarly papers and symposia with the practical insights of a broad range of professionals who are most familiar with the strengths and weaknesses of our nation's bankruptcy system.

No group is better suited to make this evaluation than the ABI membership. As the nation's largest organization of insolvency professionals, the ABI's 5,200 members represent both a substantial segment of the nation's bankruptcy professionals and a broad cross-section of practice specialties. All members received the survey, and the high response rate (1465 respondents) demonstrates the seriousness with which these professionals approach the subject of bankruptcy reform.(see footnote 18)

The ABI's diversity is reflected in the survey results. The respondents include attorneys, accountants, academics, judges, trustees, lenders, credit managers, turnaround consultants, and several other types of bankruptcy professionals. They practice in all fifty states, the District of Columbia, Puerto Rico, and the Virgin Islands. In their professional capacities they represent the interests of creditors, debtors, investors, and governmental entities. Almost all respondents have at least five years of bankruptcy experience and half have 15 years or more of bankruptcy experience. Their practice experience ranges from the simplest of consumer bankruptcies in rural America, to the most complex business bankruptcies in our major urban centers. This report reflects the collective judgment of this rich and varied pool of bankruptcy talent and experience.

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SUMMARY OF CONCLUSIONS

In the view of these professionals, the Bankruptcy Code of 1978 is working well. While there are several areas where reform is indicated, the current law receives high marks, and there is little support for major revision. This view is shared by the range of ABI members, with both debtor and creditor representatives endorsing the general thrust of the current law. However, problems of delay, excessive costs, unfairness, and abuse need to be addressed in the current round of reforms.

Abuse appears to be a small but significant problem in both consumer and business bankruptcy cases. Both debtor and creditor representatives expressed general support for strict deadlines and for either dismissal or the appointment of trustees to help combat abuse.

Similarly, both debtor and creditor representatives strongly supported the reorganization policy embodied in Chapter 11 of the current law. The debtor-in-possession concept, the automatic stay, the policy of granting an exclusive plan period to the debtor, and the cram down power ware all favored. However, endorsement of the reorganization policy is tempered by strong support for reforms aimed at making the process quicker, cheaper, and more effective. Strict time limits are supported as a response to excessive delays that are a major problem in Chapter 11 cases. Further, while the technical requirements of Chapter 11 do not appear to be interfering with the reorganization of economically viable entities, those requirements need to be modified to filter out non-viable debtors and to deal with debtor management problems more effectively. The business reorganization process also needs to be reformed to address the problem of excessive professional fees. However, on these issues there was only modest support for specific reforms such as appointing an independent financial advisor or sharing professionals.

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Although there is general support for relaxing the eligibility requirements for consumer reorganizations under Chapter 13, the current law is favored in most other respects. Time limits are strongly endorsed, as is the concept of a limited discharge. The current discharge provisions of Chapter 13 are generally supported, although there is backing for requiring a minimum distribution to unsecured creditors. There is also modest support for a uniform national exemption list.

There is strong support for the imposition of high standards of integrity for all professionals. The current law's "disinterestedness" standard for attorneys is generally endorsed, as is its extension to most other professionals. Court review of professional appointments and U.S. Trustee review of both professional appointments and fee requests are also supported.

The general support for a balance between the rights of creditors and debtors carries over to fairness among creditors. The principle of equality of distribution in bankruptcy is strongly embraced and there is strong opposition to the creation of priority classes of claim.

The consensus is that, after almost 20 years, the Bankruptcy Code still works well and needs only minor reform.

OVERALL RATING

Perhaps the most surprising of the survey is the very high overall rating of the current bankruptcy system. Half of the respondents rated it either "excellent" or "very good." Another 37 percent rated it "good," with only 3 percent rating it "poor" and 11 percent rating it fair." Although the rating remained positive regardless of the type of bankruptcy experience, there were some significant differences. Creditor representatives rated the system less highly than debtor representatives, but still 40 percent rated it either excellent or very good, and 41 percent rated good.(see footnote 19) Similarly, respondents practicing in the ten largest U.S. cities rated the system less highly than those from mixed or rural districts, with 44 percent rating it either excellent or very good and 39 percent rating it good.(see footnote 20) Geography also played a role, with relatively less satisfaction in the Second Circuit and relatively greater satisfaction in the Third, Fourth, and Tenth Circuits.

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The overall satisfaction rating was also reflected in the results of specific survey questions. For most of the potential areas of reform investigated by the survey, the respondents preferred the current law over various alternative reform proposals. The only generalizable exceptions were that there was strong support for simplifying bankruptcy law and for speeding up the bankruptcy process.

ABUSE IN THE BANKRUPTCY SYSTEM

Historically, many bankruptcy reforms have been driven by concern over perceived abuses. The survey results confine that abuse is a problem in our current bankruptcy system, but that it is not rampant. In both business and individual cases, more than half of the respondents indicated that abuse occurs only rarely or occasionally. Roughly a third reported that abuse occurs sometimes. And, abuse was reported as occurring frequently or usually by only 13 percent for business cases, and a somewhat higher 17 percent for individual cases.

However, the view changed dramatically depending on the nature of practice. While more than two-thirds of debtor representatives stated that abuse occurs only rarely or occasionally, only about one-third of creditor representatives agreed. However, even among creditor representatives only 17 percent thought abuse occurred frequently or usually in business cases and 29 percent thought it occurred frequently or usually in consumer cases. Since the survey did not attempt to define "abuse" some of the difference may represent differing views about what constitutes abuse, rather than differing views about its frequency. The differences in the views of the trustee representatives and judges were not statistically significant.

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Geography played a small role, with abuse in business cases reported as relatively more frequent in the Second, Third, and Eleventh Circuits, and as relatively less frequent in the Seventh Circuit. There was no statistically significant difference among circuits with respect to consumer bankruptcy. However, in both consumer and business cases, abuse was reported as relatively more frequent in the ten largest cities. Consumer abuse was relatively rare in rural districts, and business abuse was relatively less frequent in mixed districts.

Several specific areas of perceived abuse were investigated by the survey. While a majority felt that serial filings by individual debtors were not a significant problem, 40 percent disagreed. Although debtor representatives overwhelmingly dismissed it as a problem, almost two-thirds of creditor representatives, and slightly more than half of the judges, viewed it as a significant problem. Geographically, the problem was relatively greater in the Second, Ninth and Eleventh Circuits, and significantly smaller in the First and Seventh Circuits. Thus, serial filings are a significant problem that needs to be addressed.

In terms of abuses in business cases, more than a third reported excessive professional fees and expenses as a problem that arose always or often, with half reporting that it sometimes arose. Abusive filings were not a problem, or were rarely a problem according to a majority (55 percent), with only 8 percent stating they were always or often a problem. Further, only 29 percent listed abuse of the system by debtors as one of the top five reasons why plans are not confirmed, with 12 percent listing abuse of the system by creditors. Finally, fraud was not ranked as a major reason why confirmed plans fail.

Thus, it appears that abuse is a problem that needs to be addressed and that some aspects of the problem need to be addressed by local initiatives, rather than by federal legislation. However, abuse does not appear to be the type of systemic problem justifying the wholesale revision of bankruptcy law.

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GOALS OF BANKRUPTCY LAW

Although modern legal scholarship focuses on many non-traditional goals of bankruptcy law, only the traditional objectives received widespread support. Approximately three-quarters of the respondents said the traditional goals of providing a fresh start to debtors and of enhancing distribution to creditors should be primary objectives of a bankruptcy system. Maintaining equality of treatment for similarly situated creditors ranked a close third. Only one-half endorsed efficient claims resolution and preservation of going concern values as primary objectives, with only one-third endorsing job preservation and resolution of fraud.

CAUSES OF BANKRUPTCY

The proper design of a bankruptcy system depends, in part on the causes of financial distress. Mismanagement replied first as a primary cause of business bankruptcy, with 89 percent listing it. Market forces ranked second at 68 percent. No other cause was endorsed by a majority, although litigation/legal action and operational problems were a distant third and fourth, at 48 and 33 percent, respectively. Overall, the causes did not vary greatly from urban to rural districts. However, market forces, litigation/legal action, and operational problems were relatively more likely to be cited as a primary cause in the ten largest cities. Undercapitalization and mismanagement were relatively more likely to be cited in mixed districts. And, mismanagement, litigation/legal action, and government regulation or policy were relatively less likely to be cites in rural districts.

For consumer bankruptcy, three primary causes were each cited by two-thirds of the respondents. They were the ease of obtaining personal credit and credit cards, loss of a job, and financial mismanagement. Two additional reasons--medical problems and marital/family problems were each endorsed by 57 percent of the respondents. However, the reported causes of consumer bankruptcy did vary by type of district. In rural districts, job loss, litigation/legal action, and disaster/catastrophic event were relatively less likely to be cited. In mixed districts, medical problems and marital/family problems were relatively more likely to be cited. In contrast, medical problems and marital/family problems were relatively less likely to be cited in the ten largest cities, but job loss, litigation/legal action, business/employer failure, and disaster/catastrophic event were relatively more likely to be cited. Interestingly, there was no statistically significant difference among these types of districts with resect to either financial mismanagement or the ease of obtaining personal credit and credit cards.

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SCOPE AND DESIGN OF THE BANKRUPTCY LAW

While there was general support both for the current law's limitations on eligible debtors and for the Code's "one-size-fits-all" approach, there was also significant support for changes in the eligibility provisions and for special provisions for certain types of debtors. The survey asked whether 19 different types of entities should be permitted to be debtors under the bankruptcy laws. Although a significant number of respondents chose the "no opinion" response for several of the entities, the respondents generally opposed permitting banks and pension plans to be debtors. However, the respondents slightly favored the inclusion of bank holding companies, securities industry entities, insurance providers, labor unions, and foreign entities; and a majority favored the inclusion of bank holding companies, securities industry entities, trusts, and health maintenance organizations. Approximately two-thirds supported the inclusion of utilities and charitable/not-for-profit organizations; and, there was even stronger support for including airlines, railroads, single asset real estate entities, partnerships, family farmers, small businesses, and mass tort/product liability defendants.

Although two thirds of the respondents supported a special chapter or provisions for governmental entities, there was not majority support for separate chapters for any of the other 18 types of entities listed in the survey. The respondents were about evenly split on whether special provisions should be available for insurance providers and family farmers. However, a majority of those with an opinion on the issue favored continuing the current Chapter 12 beyond its 1998 expiration date. In addition, there was significant minority support for special provisions for banks, utilities, securities industry entities, railroads and small businesses.

The lack of consensus regarding the inclusion of special chapters or provisions for various types of entities carried through to other questions about specific areas where special provisions might be appropriate. Thus, half of the respondents felt that the length of the debtor's exclusive period to file a plan should differ depending on the type of business. Of those favoring such a special provision, the substantial majority favored shorter exclusivity periods for single asset real estate entities, but favored longer exclusivity periods for publicly-held companies, regulated industries (e.g., airlines) and governmental entities. On a related question about time limits for confirming plans, only half felt that the length of the time limit should differ depending on the type of business.

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In general, there was support for expanding the scope of Chapter 13. Fifty-seven percent supported permitting family businesses to use Chapter 13, regardless of corporate form or structure. In addition, there was significant minority support for permitting partnerships, privately-held corporations, professional corporations, and limited liability companies to obtain the type of relief currently available for individuals under Chapter 13. There was also strong minority support for increasing the Chapter 13 debt limits. While half supported the current limits of $250,000 in unsecured debts and $750,000 in secured debts, 38 percent supported increased debt limits. Further, only half supported the current distinction between secured and unsecured debts in the Chapter 13 ceiling. Those supporting the secured/unsecured distinction were asked to indicate the appropriate debt limits. While the median figures were at the current $250,000/$750,000 level, the average (mean) figures revere $365,450/$765,690, and the figures at the 75th percentile were $500,000/$999,000.

ADMINISTRATIVE AND PROFESSIONAL APPOINTMENT ISSUES

Although the automatic stay has been the subject of continual amendments and reform proposals, there was strong support for preserving the current law. First 98 percent thought that bankruptcy law should provide an automatic stay. Further, two-thirds supported keeping the scope of the stay the same as it is under current law, with the rest split evenly between narrowing and broadening its scope. Finally, almost two-thirds rejected the proposition that the stay should be for a finite period of time. However, even those supporting a finite stay strongly support (by 90 percent) making discretionary extensions available.

The problems of professional appointment and compensation, and perceptions of abuses and excessive fees, have long plagued bankruptcy law and have provided the impetus for many reform proposals. The results confirm this area continues to be problematic. Several professional issues were listed in response to the open-ended question about the three most significant problems in the current bankruptcy system. These ranged from complaints *about* professionals, such as excessive compensation and lack of competency (especially in Chapter 11 cases), to complaints *by* professionals about delays in payment and compensation procedures that are too cumbersome.

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The excessive fee concern was mirrored in the question about the frequency of various problems in reorganization cases. Excessive professional fees and expenses ranked as the second most frequent problem in business reorganization cases, behind excessive delays and immediately ahead of existing management. Thirty-nine percent of respondents indicated that excessive professional fees were a problem "often" or "always," and 50 percent indicated they were "sometimes" a problem. Only 11 percent indicated that this problem did not arise or arose rarely. Further, creditor representatives viewed this problem as relatively more frequent, with 48 percent stating it occurred often or always.

However, two partial solutions to the excessive fee issue were rejected by the respondents. Sixty-two percent rejected the suggestion that, in cases with multiple committees, the committees be required to use the same professionals (e.g., accountants, appraisers, investment bankers). Opposition to the proposal spanned practice specialties, with a majority of both business Chapter 11 debtor and creditor representatives opposing it.(see footnote 21) Committee representatives strongly opposed it (74 percent), and it was slightly opposed by judges. In addition, professionals specializing in the largest Chapter 11 cases(see footnote 22) were also strongly opposed (81 percent).

A majority also opposed the suggestion that the bankruptcy court appoint an independent financial advisor in reorganization cases to analyze and provide information to the court and creditors concerning the debtor's financial condition and viability. Here, however, significant differences were observed, with judges being slightly in favor of the proposal, business Chapter 11 creditor representatives being slightly opposed, business Chapter 11 debtor representatives being relatively more opposed, and committee Fives being the most opposed. While attorneys were opposed to the proposal, both accountants and investment bankers strongly supported it, and a majority of turnaround consultants supported it.

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A frequent complaint of bankruptcy professionals is that procedures relating to the retention of professionals are cumbersome and that the current law's "disinterestedness" standard is too strict. That view was only partly supported by the survey data. In general, the respondents supported the existing "disinterestedness" standard. Approximately 90 percent of respondents indicated that attorneys should not be disqualified for having previously represented the debtor in cases where all unpaid pre-petition fees or expenses were waived, or where the attorney is not owed pre-petition fees or expenses. Also, 84 percent indicated that previous representation of a creditor in an unrelated matter should not disqualify the attorney. Further, two-thirds indicated that an attorney should not be disqualified in cases where the attorney previously represented the debtor, but is owed pre-petition fees or expenses.

In contrast, approximately two-thirds felt that an attorney should be disqualified in cases where the attorney has previously represented the debtor and has received a potentially avoidable pre-petition transfer. Also, a majority felt that disqualification was appropriate where: (1) the attorney represents an affiliate or a principal of the debtor, (2) the attorney, or another lawyer in the attorney's firm, previously served on the debtor's board of directors; or (3) the attorney currently represents a creditor in an unrelated matter. Both professionals specializing in the largest Chapter 11 cases and business Chapter 11 debtor representatives were slightly in favor of disqualifying attorneys who represent an affiliate or a principal of the debtor, and those who previously served on the debtor's board of directors. However, both groups supported the appointment of an attorney who currently represents a creditor in an unrelated matter.

Interestingly, the respondents supported the extension of the current attorney "disinterestedness" standard to other types of professionals. While a majority supported application of the "disinterestedness" standard to auctioneers and brokers, almost two thirds supported applying the standard to appraisers and liquidators, and almost three-fourths supported applying the standard to accountants, investment bankers, and turnaround specialists. Perhaps more importantly, the professionals in each profession also supported application of the "disinterestedness" standard to their own professions. With the exception of brokers, where there were no data, there was no statistically significant difference between the views of the professionals in the subject profession and the pool of respondents on the question of whether the "disinterestedness" standard should be applied to that profession.

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Similarly, the respondents supported requiring court approval of the debtor's retention of each of these seven types of professionals. A requirement for court approval was supported by 56 percent overall for appraises, 60 percent for brokers, 61 percent for auctioneers, 76 percent for liquidators, 78 percent for accountants, and 83 percent for both investment bankers and turnaround specialists. Further, with the exception of auctioneers, brokers, and liquidators, a majority of the professionals in each profession supported a court appointment requirement. Auctioneers and liquidators did oppose a court approval requirement, but the number of respondents was too small for the difference to be statistically significant. There were no data on respondents was too small for the difference to be statistically significant. There were no data on brokers' views.

Finally, 69 percent of the respondents felt that trustees should be able to retain their own fines as professionals in the cases where they are serving as trustee. Approval was even stronger among trustees, with 88 percent supporting this proposition.

CONSUMER ISSUES

The survey investigated a range of consumer bankruptcy issues. As noted above, there was significant support for increasing the Chapter 13 debt limits and for expanding the types of entities eligible for Chapter 13-style relief. Although many consigner debts currently are permitted to pay their filing fees in installments, and the possibility of filing bankruptcy *in forma pauperis* is currently being tested in some districts, the respondents slightly opposed permitting individuals to file voluntary bankruptcy cases without first paying the full filing fee. The views of debtor representatives were not different in a statistically significant way.

Almost half of the respondents felt that the exemptions provided to individual debtors under federal bankruptcy law should be uniform for all states. Thirty-six percent supported continuation of the current "opt-out" mechanism, and only 12 percent felt that bankruptcy exemptions should be governed exclusively by state law. Dramatic differences emerged when respondents from selected states with liberal exemption policies (Florida and Texas) were compared with those from states with modest exemption policies (New York and Pennsylvania). The modest exemption respondents singly supported uniform exemptions (67 percent), with only seven percent supporting state law and 27 percent supporting the "opt-out." In contrast, the liberal exemption respondents supported the current "opt-out" rule by a bare majority (52 percent), with 20 percent supporting state law and 29 percent supporting a uniform rule. Similar results were found in a comparison of two contiguous states, one with a modest exemption policy (Missouri) and one with a liberal exemption policy (Kansas).

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In general, the respondents supported a limited discharge of debts. Respondents were asked whether various types of debts should be dischargeable "always," "sometimes," or "never." Of the 13 listed types of debts, the only type of debt that a significant number of respondents thought should "always" be dischargeable were future condominium fees or dues (39 percent). For family obligations, a strong majority felt that child support arrearages (74 percent) and alimony/spousal and child support obligations (67 percent) should never be dischargeable, but 70 percent thought that marital property settlements should sometimes be dischargeable. Sixty-nine percent thought that fraud should never be dischargeable. However, for false financial statement, only 48 percent thought that such debts should never be dischargeable, with 49 percent stating that they should sometimes be dischargeable. Other types of debts that a majority thought should never be dischargeable were drunk driving/boating liability (59 percent), intentional torts (52 percent), and restitution/criminal fines (52 percent). Approximately three-quarters thought that taxes, educational loans, and environmental liability should sometimes and two-thirds thought that bank officer/director liability should sometimes be dischargeable.

There was no consensus about the "super discharge" available in Chapter 13 cases. While 44 percent thought the Chapter 13 discharge should remain the same, 29 percent thought it should be narrowed and 21 percent thought it should be broadened. These results broke down along debtor vs. creditor lines, with 51 percent of creditor representatives favoring a narrows discharge and 37 percent of debtor representatives favoring a broader discharge. A slight majority also felt that there should be a required minimum distribution to unsecured creditors in exchange for a Chapter 13 discharge. Again, the results broke down along debtor vs. creditor lines, with 79 percent of creditor representatives favoring a minimum distribution requirement and 67 percent of debtor representatives opposing it.

Both consumer debtor representatives and consumer creditor representatives supported a time limit for confirming plans, with 86 percent of creditor representatives and 56 percent of debtor representatives in favor of time limits. Forty-three percent of those supporting time limits favored a limit of 120 days or less, with an additional 34 percent favoring a 180-day limit, and 20 percent favoring a one-year limit. Of those favoring time limits, half thought that a trustee should be appointed if no plan was confirmed within the time limit; the remedies of liquidation and dismissal were each supported by about a quarter. On the question of what circumstances would justify dismissal of a liquidation case, there was general agreement between debtor and creditor representatives. Strong majorities supported dismissal for (1) nonpayment of required fees and charges, (2) failure to file required schedules of assets and liabilities and/or statements of financial affairs, (3) "bad faith" filings, and (4) unreasonable delay by the debtor that is prejudicial to creditors. A strong majority of creditor representatives, and a 56 percent majority of debtor representatives supported dismissal based on serial filings. And, while a majority of creditor representatives supported dismissal where the debtor had current ability to repay debt, only 38 percent of debtor representatives supported dismissal on that ground.

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BUSINESS REORGANIZATION ISSUES

Although the debtor-in-possession concept has come under significant criticism, the survey respondents strongly supported allowing debtors in business reorganizations to remain in possession of their property, retain all of their rights and powers, and operate their businesses. Almost three-quarters of creditor representatives and 93 percent of debtor representatives supported the debtor-in-possession concept. However, despite wide support for the basic concept, it appears that there are substantial problems in practice. Mismanagement ranked first among the causes of business bankruptcy. Further, existing management was ranked as the third most common problem in business reorganization cases, with 37 percent stating that existing management was "often" or "always" a problem, and 53 percent stating that it was "sometimes" a problem. Only 10 percent indicated that existing management was not a problem or rarely a problem. In addition, mismanagement was ranked second among the reasons why confirmed plans in business reorganizations fail. These results suggest that reform efforts need to be directed towards the early identification and resolution of management problems in business reorganization.

The respondents expressed mixed views on granting special rights or remedies to post-petition lenders. The only rights with majority support were the granting of origination and other "up front" fees (60 percent), validation of pre-petition liens/interests (57 percent), and binding effect on a subsequently appointed trustee (67 percent). The respondents slightly favored granting liens on avoidance action recoveries. However, a majority opposed granting veto power over payments to professionals (82 percent), bootstrapping of liens and claims from pre-petition to post-petition (61 percent), the waiver of avoidance actions against the lender (53 percent), and the waiver of other claims against the lender (such as lender liability claims) (53 percent). Except for relatively stronger opposition to bootstrapping, there was no statistically significant difference in the views of the professionals specializing in the largest Chapter 11 cases. However, opposition to bootstrapping, waiver of avoidance actions, and waiver of other claims was relatively stronger in the districts with the largest reorganization cases.(see footnote 23)

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Only a minuscule three percent supported elimination of the debtor's exclusivity period for filing a plan of reorganization. Forty-five percent supported the current laws 120-day exclusive period, With 24 percent supporting a longer 180-day period and 17 percent supporting a slightly shorter 90-day period. Only half thought that the exclusivity period should differ depending upon the type of the debtors business. Of those, a majority thought that publicly-held companies, regulated industries (such as airlines, etc.), and governmental entities should have more than 120 days. Only single asset real estate cases garnered majority support for an exclusivity period of less than 120 days.

A majority (62 percent) of all respondents supported a time limit for confirming a plan in reorganization cases. The time limit was supported by 75 percent of business Chapter 11 creditor representatives, but by only 39 percent of business Chapter 11 debtor representatives. Of those supporting a time limit for confirmation, half supported time limits of 180 days or less, with 38 percent supporting a one-year limit and 11 percent supporting a two-year limit. A slight majority thought that the time limit for confining a plan should differ depending upon the type of the debtor's business.

The respondents were split on the consequence of missing the time limit. A plurality (41 percent) thought that a trustee should be appointed, with 19 percent supporting dismissal of the case and another 19 percent supporting liquidation. Finally, 15 percent thought there should be no consequence. Among those who favored time limits on confirmations, half thought that the consequence should be appointment of a trustee, with about one-quarter each supporting liquidation and dismissal. Among those opposing time limits, about one-third each supported appointing a trustee and doing nothing.

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The combined results of the debtor-in-possession, exclusivity, and time limit questions indicate strong support for a limited right to reorganize. The results suggest a reorganization provision that, in the typical case, grants a short exclusivity period to the debtor, followed by the appointment of a trustee within six months to a year if no plan is confirmed. Longer periods, or discretionary extensions could be available in more complex cases, such as those involving publicly-held companies, regulated industries, and governmental entities.

Consistent with the general support for time limits on exclusivity and plan confirmation, time-related issues ranked first and fourth among the most common problems in business reorganization cases. Excessive delays ranked first with 46 percent indicating that they were "often" or "always" a problem, and an additional 46 percent indicating that they were "sometimes" a problem. Excessive professional fees and expenses ranked second, with 39 percent indicating that they were often or always a problem, and an additional 50 percent indicating that they were sometimes a problem. Existing movement ranked third, with 37 percent indicating that it was often or always a problem, and an additional 53 percent indicating that it was sometimes a problem. Excessive time in bankruptcy before conversion or dismissal ranked fourth, with 36 percent indicating that it was often or always a problem, and an additional 47 percent indicating that it was sometimes a problem. Excessive secured creditor influence ranked fifth, with 31 percent indicating that it was often or always a problem, and an additional 49 percent indicating that it was sometimes a problem. There were no other issues for which the combined percentage of "often" and "always" responses significantly exceeded the percentage of "rarely" and "not at all" responses. However, the remaining issues garnering the greatest percentage of often and always responses were (6) ADR utilization, (7) insufficient access to information; (8) exclusivity extensions; (9) insufficient committee involvement; and (10) insufficient uniformity (e.g., local rules).

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The respondent strongly supported both the "cram down" power and a "new value" exception to the absolute priority rule. Eighty percent thought that a plan should be confirmable without acceptance by all impaired classes of claims. Although an overwhelming 95 percent of business Chapter 11 debtor representatives supported the cram down power, it also was supported by 73 percent of biomass Chapter 11 creditor representatives. A new value exception to the absolute priority rule was supported by three-quarters of respondents. It was supported by 91 percent of business Chapter 11 debtor representatives, and also was supported by 70 percent of business Chapter 11 creditor representatives.

When asked to identify reasons why plans are not confirmed, only three reasons were endorsed by a majority of respondents. Eighty-five percent listed lack of economic viability, 77 percent indicated that the plan was not feasible, and 71 percent listed insufficient financing. Four other reasons were endorsed by approximately one-quarter of the respondents. They were (1) abuse of the system by the debtor, (2) inability to obtain requisite votes, (3) desires results obtained without need for confirmed plan, and (4) low of collateral through foreclosure. Only 12 percent indicated that plans are not confirmed because confirmation standards are too technical. Confirmation is only one of the steps towards a successful reorganization and, unfortunately, a very large percentage of confirmed plans in business reorganization cases fail. The primary reason that confirmed plans fail, according to the survey respondents, is unrealistic financial projections. Mismanagement ranked a distant second, with unforeseen external events or circumstances coming in a very distant third. These responses suggest that the confirmation process is working in the sense that economic problems, rather than technical or procedural problems, are the primary impediment to plan confirmation. However, the confirmation process is not filtering out enough of the plans with significant economic problems and is not dealing effectively enough with management problems.

COURT ISSUES

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Granting Article III status to bankruptcy judges was supported by 62 percent of respondents. However, there was a significant difference in opinion by professions, with 78 percent of judges supporting Article III status and 64 percent of attorneys supporting it, but only 48 percent of other professionals supporting it. While granting Article III status to bankruptcy judges would permit simplification of the bankruptcy jurisdictional provisions, jurisdictional battles were rated as the least frequent of 19 surveyed problems in business reorganization cases. Further, while those supporting Article III status reported a slightly higher frequency of jurisdictional battles as problems in business reorganization cases, even among those respondents jurisdictional battles were rated as a problem "rarely" or "not at all" by 70 percent, and as a problem "often" or "always" by only seven percent.

There was strong support for Bankruptcy Appellate panels as the initial venue for appeals from the bankruptcy court. Overall, 56 percent felt that bankruptcy appeals initially should be taken to the Bankruptcy Appellate Panel, with only 20 percent favoring the United States District Courts, and only 21 percent favoring direct appeals to the Circuit Court of Appeals. An even sponger endorsement of Bankruptcy Appellate Panels comes from Ninth Circuit professionals, who have long had a Bankruptcy Appellate Panel. Among Ninth Circuit professionals, 70 percent favor the Bankruptcy Appellate Panels, with only 14 percent favoring the United States District Courts, and only 16 percent favoring direct appeals to the Circuit Court of Appeals. The high level of satisfaction in the Ninth Circuit suggests that the Bankruptcy Appellate Panel reform should be carried forward.

POLICING THE SYSTEM

Although current law relies on both the Office of the U.S. Trustee and, in business reorganization cases, official committees to help ensure that the bankruptcy system operates fairly and efficiently, both received mixed reviews from survey respondents. In response to an open ended question, the U.S. Trustee system was cited by many respondents as one of the three most significant problems in the current bankruptcy system. However, there was strong support for an active U.S. Trustee role in cases without committees, and moderate support for such a role in cases with committees. Further, the U.S. Trustee appeals to be actively performing its role, since few respondents listed lack of U.S. Trustee involvement as a problem in reorganization cases.

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With respect to the scope of that role, more than two thirds of responders indicated that the U.S. Trustee should be responsible for protecting non-debtor interests in cases without committees. There was very strong support for an active U.S. Trustee role in virtually all aspects of such cases, with only post-confirmation matters (at $4 percent) falling below the two-thirds support level. While the level of support for an active U.S. Trustee role diminished for cases with committees, approximately half or more supported an active role in virtually all aspect of such cases, except post-confirmation matters (29 percent), compensation of debtor's management (43 percent), and the plan confirmation process (44 percent). Although professional compensation and retention issues are often a source of conflict between bankruptcy professionals and the U.S. Trustee, there was very strong support in cases without committees for U.S. Trustee involvement in the retention of professionals (74 percent) and compensation of professionals (72 percent). There was far less support for those roles in cases with committees. Only 49 percent supported a role in the retention of professionals, while 53 percent supported a role in the compensation of professionals. On the range of issues, business Chapter 11 debtor representatives tended to be the least supportive of the U.S. Trustee's role in cases with committees, while judges tended to be the most supportive.

The official committees were generally viewed as providing a necessary balance (59 percent) and serving a necessary function (64 percent). Only 2 percent said they were never necessary. However, professionals specializing in the largest Chapter 11 cases viewed the committees much more favorably, with 80 percent stating that committees provide a necessary balance and 75 percent stating that they perform a necessary function. Also, committee representatives were much more likely to indicate that committees provided a necessary balance (79 percent) and performed a necessary function (85 percent). Respondents from the ten largest cities were relatively more likely to indicate that committees were necessary, while those from rural districts were relatively less likely to do so.

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The majority indicated that the level of committee utilization was about right, although a substantial minority indicated that committees were appointed in fewer cases than necessary (35 percent) and a small minority indicated that they were appointed more often than necessary (16 percent). Interestingly, the views of committee representatives varied from the overall pool of respondents only slightly, with committee representatives less likely to indicate that committees were appointed more often than necessary.

The extent of committee involvement appears to be a problem in many cases, with 27 percent listing insufficient committee involvement as a problem that always or often occurs in business reorganization cases. An additional 35 percent listed it as a problem that sometimes occurs. These results suggest that the committee concept needs rethinking. While the committee vehicle may work satisfactorily in larger districts, or bigger cases, it may not be the best method for protecting non-debtor interests in other cases.

PREFERENTIAL TRANSFERS

There was general agreement that intent to prefer a creditor should not be added as a necessary element for avoiding a preferential transfer. Overall, only 26 percent of respondents supported such a change in the law. Even among business Chapter 11 creditor representatives only 30 percent favored an intent requirement.

VALUATION

The majority (52 percent) did support a change to provide a specific valuation standard in bankruptcy cases, with fair market value being the preferred standard for most purposes. While creditor representatives were more supportive of adopting a specific valuation standard (58 percent) and trustee representatives were less supportive (43 percent), there was no statistically significant difference in the views of debtor representatives or judges.

The respondents were deeply divided on the question of what valuation standard should be adopted. However, a plurality favored a fair market valuation for all purposes except confirmation. For solvency determinations, more than 40 percent favored a fair market valuation, with about a third favoring a liquidation valuation and about a quarter favoring a going concern valuation.

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On exemption issues, the pool was more divided, with 47 percent favoring a fair market value and 42 percent favoring a liquidation value. Here the views divided along debtor vs. creditor lines, with 62 percent of debtor representatives favoring a liquidation value ant 57 percent of creditor representatives favoring a fair market value.

For confirmation issues, a plurality of 45 percent favored a going concern valuation, with 36 percent favoring a fair market valuation. A going concern valuation for confirmation issues was the most favored choice of both debtor representatives and creditor representatives; however, debtor representatives were almost evenly divided among the three standards, while creditor representatives were almost evenly split between a going concern valuation and a fair market valuation.

With respect to secured creditor issues, fair market valuation was the most favored choice for cash collateral and adequate protection purposes, and was the majority choice (53 percent) for valuing collateral. On an three issues, creditor representatives favored a fair market valuation, whereas debtor representatives were split with approximately two-fifths favoring a liquidation standard and two-fifths favoring a fair market standard.

CLAIMS

There was general opposition to granting specific categories of claimants priority over unsecured creditors. Respondents were asked to indicate whether 19 types of claims should always, sometimes, or never be given priority over general unsecured claims. The majority supported always prioritizing only two classes of claims: (1) the expenses of administration (77 percent), and (2) alimony/spousal and child support claims (50 percent). Seven additional classes garnered majority support for at least sometimes receiving priority. In descending order of their combined "sometimes" and "always" percentages, they were: (1) wages (92 percent); (2) employee benefits (82 percent); (3) taxes (77 percent); (4) pension/retirement claims (74 percent); (5) reclamation claims (62 percent); and (6 & 7) a tie between restitution/criminal fines and marital property settlement claims (each at 54 percent).

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Consumer debtors often attempt to prioritize non-dischargeable claims and health care claims in their Chapter 13 plans. However, with the exception of the family obligations and restitution/criminal fines noted above, a majority rejected priority treatment of such other nondischargeable claims as drunk driving/boating liability and educational loans, ant rejected priority treatment of health care claims.

In business cases, priority is granted to fishermen. Certain other claims often receive a *de facto* priority because of restrictions on contract rejection for collective bargaining agreements, restrictions on abandonment for environmental liabilities, and statutory "trust" provisions such as the Perishable Agricultural Commodities Act (PACA). A majority rejected priority treatment for each of these types of claims. Finally, there have been reform proposals advocating a priority for non-tax governmental claims and a priority for involuntary creditors such as tort claimants. However, three-quarters of the respondents rejected priority treatment of non-tax governmental claims and of mass tort/products liability claims.

Difficult policy choices and practical problems are presented by tort claims, environmental liability, and certain other claims that are not yet liquidated at the time of plan confirmation. The majority (52 percent) favored estimating such claims for both voting purposes and distribution purposes. Approximately one-quarter favored estimating the claims for voting purposes only. Only eight percent felt that the claims should be unaffected by confirmation, with less than five percent supporting either disallowance of such claims or delaying confirmation until the claims could be liquidated. There was no statistically significant difference in the views of those professionals specializing in the largest Chapter 11 cases.

With respect to claims trading, 56 percent of respondents felt that the transfer or sale of claims (other than publicly-traded claims) should not be subject to court approval. Opposition was even stronger in the districts with the largest reorganization cases, with 63 percent opposing a court approval requirement. Of those favoring a court approval requirement, there was no consensus as to the nature of the court's review. Respondents favoring court review were asked about four possible standards for that review and were asked to identify all that should be considered by the court. However, none was endorsed by even a third of those respondents. Only 30 percent thought the court should review the adequacy of disclosure, and only 29 percent thought the court should review the impact that the transfer would have upon the reorganization process. Only 15 percent thought that the court should review the price paid and only 12 percent thought that the court should review the impact that the transfer would have upon competition.

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Further, although claims are often purchased at a price well below face value, 68 percent believed that the rights of the purchaser (the transferee) of a claim should be based upon the face amount of the claim, rather than the price paid for the claim. There was no statically significant difference in the views of those professionals specializing in the largest Chapter 11 cases.

Finally, in both claims trading and in certain other situations, the same claimant may hold multiple different claims that are included in a single class under the plan of reorganization. A small majority (52 percent) felt that in such cases the owner should not be treated as a single claimant, but rather as one claimant with respect to each claim owned. However, the opposite view prevailed among those professionals specializing in the largest Chapter 11 cases, with 57 percent favoring treating the holder of multiple claims as a single claimant.

INSERT OFFSET RING FOLIOS 4 TO 8 **HERE**

Mr. **NADLER.** Of this year?

Mr. **TATELBAUM.** In 3 weeks.

I practice in the Bankruptcy Court in the Virgin Islands and while it may not be the busiest Bankruptcy Court in the country, they have had two major storms there in the last 2 years and there are many small businesses and individuals who need that relief. And maybe the subcommittee could consider as part of the technical corrections bill something to be done about that. But it is a very short-term crisis as opposed to the rest of the issues I discuss.

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Mr. **GEKAS.** Hasn't there been a stay ordered in that case?

Mr. **TATELBAUM.** Until the 28th of April.

Mr. **GEKAS.** Oh, the stay is only to the 28th?

Mr. **TATELBAUM.** Yes, sir.

Mr. **GEKAS.** Thank you. We now turn to Judge Paine.

STATEMENT OF GEORGE C. PAINE II, CHIEF JUDGE, U.S. BANKRUPTCY COURT, MIDDLE DISTRICT OF TENNESSEE, ON BEHALF OF THE NATIONAL CONFERENCE OF BANKRUPTCY JUDGES

Judge **PAINE.** Thank you, Mr. Chairman and members of the subcommittee, particularly my home State Congressman, Mr. Bryant. I am delighted to be here before you today to speak on behalf of the National Conference of Bankruptcy Judges, an organization of over 300 active bankruptcy judges who are laboring in the trenches over the issue that you are focusing on today.

My purpose is to give you an overview of a judge who has been immersed in the system since 1981.

As an aside, you have already mentioned my on-the-job training in Vietnam for the bankruptcy bench, and that certainly came in useful in the 1980's, which were a turbulent economic time and a time of chaos. I have to also say, given all things, I would rather be on that side of the bench asking questions than on this side being questioned. I hope I won't need to resort to my ancient skills from Vietnam to defend myself before the committee.

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In 1978, Congress drastically changed bankruptcy law. They changed the structure of the court and the current law as we now know it. And they did it because of the changed economic circumstances since the last restructuring in 1938.

What they did in regard to the court is to repose for purposes of economy and efficiency most of the power to deal with the consumer cases and business cases in one forum with one judge. This was to deal with a fairly unique animal--the bankruptcy case.

It is unique from other lawsuits in the sense that we have a diminishing pot of money. We can sit there and watch it go down, so we have to take action quickly. It is a matter where most people are going to take losses. It is a rare case when a creditor in a bankruptcy doesn't take a loss. It is a case that has a ripple effect. Certainly in a consumer case it impacts a family or extended family; and, in a business case, it impacts a community, society, and the governmental agencies that interact with the business, whether they expect taxes to be paid by them or they regulate them. It is a matter that a judge or the court with its marketplace character, and the law, has to as equitably as possible apportion the distribution of assets and distribution of losses among the parties.

This relatively untested court fared incredibly well in the 1980's. The law didn't change but the economy changed. These were unanticipated changes. We had the S&L failures; we had the bank failures; we had the farm crisis; we had the collapse of the tax havens; we had the leveraged buyouts; and, we had the flight of jobs from obsolete industries to Asia and the Caribbean.

While these events were unanticipated, the court functioned remarkably well during that time. I know the number of judges went up by a half in the 1980's and yet their caseload went up by three and a half times. Throughout this period the judges continued to operate an efficient, fast track court, largely as a consequence of the judges' dedication and a lot of innovations they applied within the law that Congress had written to expedite cases through the courts.

One of the interesting aspects of this era is with this new law and the marketplace nature of the court we saw a shift in the focus of bankruptcy from liquidation to reorganization and repayment in consumer cases and business cases. I am quite proud of the way the courts reacted in the 1980's with this explosion of cases, and I would like to congratulate Congress on its foresight in creating a law that would anticipate things that we never imagined, some of which have been mentioned today to the earlier panel along with the unanticipated explosion in credit of the recent 2 or 3 years. The law is working incredibly well on issues we never imagined it would have to address.

We think the review of the current law by the Commission and Congress is healthy for everyone concerned, and we recognize the obligation and duty of Congress to do this. I would like to congratulate this subcommittee for looking at a very arcane and complex area, but one that does affect your constituents and communities on a daily basis. We look forward to working with you and giving you any assistance we can in this area. Thank you.

Mr. **GEKAS.** We thank the gentleman.

[The prepared statement of Judge Paine follows:]

PREPARED STATEMENT OF GEORGE C. PAINE II, CHIEF JUDGE, U.S. BANKRUPTCY COURT, ON BEHALF OF THE NATIONAL CONFERENCE OF BANKRUPTCY JUDGES

Mr. Chairman, members of the Subcommittee, I am George C. Paine, II, the Chief Judge of the United States Bankruptcy Court for the Middle District of Tennessee. I have been in service on the bankruptcy bench since 1981.

I appear today on behalf of the National Conference of Bankruptcy Judges. The NCBJ was organized in 1926 as a voluntary non-governmental association of bankruptcy judges. Its primary purpose is education, promoting improvements in the practice of law and the administration of justice in the bankruptcy courts of the United States.

The NCBJ does not take positions on substantive provisions of bankruptcy law. Within the confines of the Canons of Ethics, the NCBJ and its individual judge-members are available as a resource for commentary on the Bankruptcy Code and proposed changes considered by Congress.

As an aside and from a practical standpoint, because of the diverse and myriad experience of our members, there is little consensus on most issues. Just as an example, I am aware some of our members support an Article III court, others feel the current Article I status is working well. Accordingly, we do not advocate or promote a position on whether bankruptcy judges should be appointed under Article I or Article III.

In 1978, Congress created a new specialized bankruptcy court with considerably increased jurisdiction and a dramatically changed law. The impetus for this new law was the evolution of this country's economy since the previous restructuring of bankruptcy law in 1938. Your colleagues in the House and Senate and numerous experts thoughtfully studied and debated these current provisions from the early 1970s to the passage of the Bankruptcy Reform Act in 1978.

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It is both the court you created and the law you enacted that I would like to address from a judge's perspective in 1997.

We are a specialized court staffed by judges with considerable experience in commercial law. It is the only judicial position in the federal court systems where an applicant's qualifications for consideration--not appointment--must pass a stringent statutory test of seven specific standards. These qualifications are then assessed by a merit screening panel, and if deemed insufficient, the applicant is eliminated from further consideration for a bankruptcy judgeship.

No one imagined when this court was restructured in 1978 that the bankruptcy court would become the commercial court of the United States. Because of the knowledge and expertise of the judges, and the speed of disposition, it became the forum of choice for creditors and debtors who could have their issues resolved quickly and efficiently in a court that realizes time is money and that no one benefits from delay in commercial matters.

Last week I witnessed a practical example of this expediency. Both the debtor, in one of the largest personal asset bankruptcy cases in our district, and a very sophisticated creditor opted to resolve their dispute over real estate partnership interests claimed by a state regulated insurance company in receivership within the bankruptcy court rather than risk protracted delay in state court, and the uncertainty of experience of state court judges with respect to commercial matters.

In the 1980s, the commercial world discovered the bankruptcy court as the preferred forum. The bankruptcy court proved itself competent to deal with almost any economic and business problem. Mass tort litigation cases were resolved with a maximum recovery to the tragic victims, while protecting the jobs of the thousands of innocent workers employed by tort feasor companies. In addition to mass tort litigation resolution, our courts deal with everything from failing airlines to economically obsolete steel mills. In a more provincial setting such as mine, I consider among other things auto dealerships, barge companies, nursing homes, hospitals, trucking companies, manufacturing firms, an airplane charter service, farms, country music performers, a water utility district and even the Nashville Symphony. This is in addition to the hundreds of thousands of ordinary American consumers who are at the limit of their ability to repay debt and are driven by job lay offs, job loss, separation, divorce, medical problems or an accident to file for bankruptcy protection.

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The commercial world has come to expect from bankruptcy judges a quick and high quality resolution to their problems in commercial litigation.

The bankruptcy court has implemented numerous innovative case management efficiencies to deal with the onslaught of filings in the last decade. Recognizing the time is money principle, we are aware that creditors must recover their entitlements as quickly as possible. In 1984, there were 232 judges and 348,521 cases. In 1996, there were 326 judges and 1,178,555 cases.

To be sure we absolutely need the requested eighteen additional bankruptcy judgeships, but it is stunning that far more are not requested--a testament to the competent work being done by the bankruptcy judges of this country. The need for some of the requested new positions goes back to 1992 and the case load has increased considerably since then.

In 1994, because of the success of the bankruptcy appellate panels in the Ninth Circuit, Congress passed legislation to implement BAPS nationwide. Several more circuits have created BAPS and my Sixth Circuit is one of them. I believe that time will show that a specialized appellate court will give a speedier resolution to appeals within the bankruptcy system--in large part because of the overwhelming caseload of the United States district courts and their ever expanding jurisdiction. Further much needed precedence will be created to avoid unnecessary litigation at the trial level and additional cost savings to parties.

In 1986, Congress created a nationwide U.S. Trustee system to provide oversight responsibility on the trustees and cases before the bankruptcy court. In my district, the U.S. Trustee is a vital and welcome participant providing the court and litigants with excellent service. However, while the system works in my district, it is reported that it does not in others, apparently as a consequence of the competence of personnel and/or availability of resources.

As bankruptcy law has developed, so has the expertise, competence, and awareness of the bankruptcy bar. A bankruptcy practitioner must know commercial, real estate, domestic relations, environmental, tax, and some times securities and employment law, in addition to being a skilled negotiator and litigator. As the sophistication of the law has grown, so has the competence of bankruptcy lawyers. The same is true of creditors. They have become excellent negotiators and well aware that expedient courts make their bottom line recovery greater. This has required judges to increase their expertise as well.

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The last component to an effective bankruptcy system I would like to mention is the Administrative Office of the U.S. Courts and particularly its Director L. Ralph Mecham and the Chief of the Bankruptcy Judges Division Francis F. Szczebak. They provide us with excellent training, clerical support, computer expertise, creative procedures and statistical data to analyze our effectiveness.

The provisions of the 1978 Bankruptcy Code and the subsequent amendments work remarkably well, in spite of the continued evolution of our economy. This is testimony to the thoughtfulness and consideration that went into enactment of this legislation by Congress.

Twenty years' experience has seen the focus of bankruptcy law shift from liquidation to reorganization and repayment of debt.

Few people consider the tremendous benefit from a corporate reorganization. Jobs are saved that are vital to a community. Suppliers and retailers maintain critical customers. Employees remain as taxpayers rather than unemployment recipients. Taxes are generated for local, state and federal governments.

Consumer debtors are returning billions of dollars every year to the economies of their communities through personal reorganization under Chapter 13 of the bankruptcy code and under the supervision of the judges.

The money Chapter 13 debtors pay back to creditors is phenomenal. In the relatively rural 33 counties of the Middle District of Tennessee, over $73 million is paid annually to creditors by Chapter 13 debtors. Over $2 billion passes through the Chapter 13 program annually nationwide. Chapter 13 debtors find relief from the irresistible deluge of available credit and for the first time in their lives set up a budget that realistically considers their income and expenditures. They commit to pay their debt over an extended period of time without taking on more credit and they end up with the satisfaction of having disciplined themselves to go back into the marketplace as more educated consumers of credit. This is what used to be taught in the home, schools and religious institutions and is now dealt with in the bankruptcy court. To this end, our Chapter 13 office like many around the country, employs a professional debt counselor to aid the debtors in the education process.

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The people who find their ways to the bankruptcy court for an equitable resolution of their debt problems are basically your constituents. They include people laid off by down-sizing, mom and pop business owners, and hard-working families who want to pay their debts but fear losing their home. Without the protection of bankruptcy, these constituents become unproductive citizens. Small businesses depend on quickly receiving the portion of bad debt they can obtain and we do it daily for them.

The American middle class worker with minimal real income growth, increased expenses and unlimited credit availability can find the relief but at a cost of disclosing their affairs to the world and scrutiny of a trustee, the court and their creditors.

Overall, the bankruptcy system is working remarkably well within its resources and constraints. However, we recognize that the economy is changing and Congress has an obligation to review the Bankruptcy Code.

As a commercial court attuned to the marketplace, we know as well as anyone what is occurring. The economy is booming, yet bankruptcies are increasing. Since 1975, 25 million new jobs have been created; the number of businesses has increased by almost 75 percent and retail sales have increased by over 300 percent. One out of every six families has financial problems because of credit cards, yet 28 percent of all cardholders pay their bills in full each month. In 1996, almost $20 billion dollars in consumer debt was repaid,(see footnote 24) but Americans owed 8.3 percent more debt ($1.95 trillion) at the end of 1996 than they owed in 1995.(see footnote 25) Credit card debt increased during that same period from $413.9 billion to $462.8 billion.(see footnote 26) Over the last three years Americans received more than eight billion offers for credit cards in the mail.(see footnote 27)

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These are fascinating economic times we live in. The bankruptcy judges of the country have a unique perspective and expertise to be a resource to Congress as you embark on your review of the bankruptcy system. We look forward to providing whatever assistance is needed on any bankruptcy issue. Consider us your allies, available and ready for any assistance or information.

I greatly appreciate your inviting me here and I look forward to answering any questions you might have.

Mr. **GEKAS.** The Chair yields itself 5 minutes.

Mr. Tatelbaum, it seems ironic that the burgeoning economy, we have more bankruptcies. Did you mean to imply or to assert that one causes the other in a change pattern?

Mr. **TATELBAUM.** Well, Mr. Chairman, one may affect the other, and I don't mean to be a play on words between cause and effect, but the Chair's perception is correct. When there is a good economy, and this is historically proven, when there has been a good economy, at least in the latter part of this century, and the average consumer has money to spend, they will spend.

What has happened this time is the so-called X-generation and so-called yuppies, who I think are the generation before them, both after me, now feel that savings is not important, and with the increase in the credit card availability and things like that, the good economy produces a lot of spending. Because people are not afraid, they are not saving. They are not worried about being laid off; they are not worried about recession. And that will create debt.

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There is a chart at the end of our materials entitled "Influence of Total Consumer Debt on Bankruptcy Filing Trends" for 1991 to 1996.

Mr. **NADLER.** What page is that on?

Mr. **TATELBAUM.** Right before the first salmon-colored marker. And that, I think, statistically shows from the Administrative Office of the U.S. Courts, the response to some of the Chair's question.

Mr. **GEKAS.** That seems to make our job even more difficult because the moral rationale would be that we need the bankruptcy system as a bulwark against bad times. We now need it against good times as well.

Mr. **TATELBAUM.** Yes, sir, on the consumer side you certainly do. There may be a dichotomy in the business side due to business cycles. Because things happen. There is a bumper sticker that is popular in our industry which says "bankruptcy happens." And it does. There are certain time lines after recession and other things, but in good economies, consumers file more bankruptcies.

Mr. **GEKAS.** Judge Paine, you seem to be asserting that maybe we shouldn't do too much. That the system is fairly well adapting to all the possible situations and that maybe we could be foolhardy in overtinkering, even with the pending report's recommendations.

Judge **PAINE.** I apologize if I left that impression with the subcommittee. I think it is healthy to look at how well the law is working and how it could be refined to work even better. Quite frankly, though, I think regardless of what occurs, the Bankruptcy Court will still continue to function as it is, a court of last resort.

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When other courts cannot resolve problems, the Bankruptcy Court does. That is what happened in the mass tort litigation area. Nobody imagined these tragic cases. Yet it seemed to be in everybody's best interest to come to Bankruptcy Court and create a solution. Whether it is the best solution, we will never know. But it was a solution that could not be reached in the Federal district courts or the State courts.

Mr. **GEKAS.** In a side-bar conversation that the gentleman from New York and I had, we noted that the Congress acted several years ago and has done some product liability correction in the Piper Cub General Aviation situation.

We also have product liability reform pending on a whole set of fronts which we hope might have the same salutary effect. Congress could act as a preventive agent so that we don't get the bankruptcy but it rather cure the main problem, the problem of liability.

Does that concur with your general thinking?

Judge **PAINE.** It does.

Another example that comes to my mind is the family farmer chapter that was created by Congress in the 1980's to deal with a terrible situation in the farm community. It gave a forum for creditors and farmers to work out their problems. Now we rarely see chapter 12 farm bankruptcies because everybody is working within the constraints of the family farm bill. They do not have to resort to court action anymore.

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Mr. **GEKAS.** The time of the Chair has expired. I recognize the gentleman from New York.

Mr. **NADLER.** Thank you, Mr. Chairman.

Let me first observe that, and this gets a little into the economic side, not the legal side, but this is being raised, the fact that historically bankruptcies are associated with bad times and in recent years they are associated also with so-called good times could have a number of explanations.

One explanation certainly is, is that it used to be that people had fairly stable jobs. In bad times, the steel factory laid off 2,000 workers and when business picked up they rehired the same 2,000 workers and those 2,000 workers were on unemployment health insurance and they did not go bankrupt; except for in the Depression.

But now for various reasons, economic dislocations, the company that is making a lot of money lays off 10,000 people, and maybe they find jobs in other fields or maybe not, but when they are laid off, and it is they are not going back to the same company 6 months later, and whatever is causing those dislocations, increase in the total number of jobs in the economy and the general standard of living is going up, you still have 10,000 people laid off, not likely many of them will find another job for a long time and they are not likely to find another job at comparable pay for a very long time, so you are going to get a number of bankruptcies out of that.

Simply, in the last 20 years a very large fraction of the increase in our total income in the country is going to a very small subset of people, and for a very large number of people they are not getting any benefit. In fact, average wages for working people has gone down in the last 20 years, not up. The bifurcation of income will lead to bankruptcies.

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So there are some fundamental things going on that would do that, and the question is, should you call that good times. That is another question.

Let me ask a specific question. I raised this with the previous panel. I would like your input.

We have heard that one of the problems is that you have a lot of small business bankruptcies and, of course, courts are overburdened. I certainly think we should pass a bill creating lots of new judgeships this year because of the overburdening, certainly at least 18. But small businesses have to wait a long time. They may be in the same court with a very complicated bankruptcy. Would it be advantageous to have a separate part by which--I do not mean a separate court, but a separate part. In the State court system, in New York, in the supreme court, you have a divorce part and a commercial part and this part and that part, and a judge will sit in the divorce part for a month and then go to the commercial part and so forth. And the parts might have different rules.

It would, I imagine, be difficult to have different rules for different litigants in the same part, and you have to decide, well, in this case because the small business set of rules applies and in a different case that set, but you could have a simplified set of rules, less expensive, less time consuming if you had a separate part where the only litigants there were small business bankruptcy cases, however we chose to define that or the Commission chose to define that.

And I know that the judges probably wouldn't like to sit there because it is less intellectually stimulating, but they would only sit there a month and then go on to the General Motors bankruptcy case or whatever. Would you think that something like this might be a helpful suggestion?

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Judge **PAINE.** If I could address this from a personal standpoint and not on behalf of my colleagues, case jurisdiction is all local. In Nashville, TN, we do not have a problem with the small cases going through the system quickly and efficiently. However we do not have the large megacases like the Southern District of New York or the Southern District of Florida.

I would prefer to in my district continue working on all the cases. I enjoy the consumer cases as much as I enjoy the large cases. They give one a lot of satisfaction to help people who have real problems. And you almost relegate them to a status below the business cases if you don't give them equal treatment.

Mr. **NADLER.** Excuse me, the idea is not to give them less than equal treatment but to give them a simplified set of rules.

Let me ask you in light of what you are saying if you might think it a useful idea if we were to amend the law to give, let's say, the Conference of judges or the Chief Judge in a given district the authority to institute that sort of part system if they wished?

Judge **PAINE.** That would be an interesting result and courts would be able to adapt whatever system they wanted to.

Mr. **NADLER.** We would give them a choice of one or two or three?

Judge **PAINE.** Right. What I really was trying to say is that we find when people give the consumer cases to the lowest judge on the totem pole it is saying something about how you are dealing with those cases. I am a little leery of saying----

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Mr. **NADLER.** I agree. You shouldn't give it to the most junior judge all the time. I am thinking of a situation where every judge would sit there for a month, let's say, and rotate out of there and whatever other parts there might be.

What would you think of that kind of arrangement at the discretion of either the body of local bankruptcy judges or the Chief Judge?

Judge **PAINE.** That would be a great option for the local court to have and we usually find these solutions on our own when problems arise.

Mr. **NADLER.** Do you have the authority to do that now under the current law?

Judge **PAINE.** I think I could find it.

Could I add something. I didn't want to leave the impression when I congratulated the judges for their handling of the cases that we do not need the additional judgeships we have asked for. Some of those requests have been pending since 1992, and there has been an explosion of cases since then. I know the Western Districts of Tennessee, Pennsylvania, and Massachusetts or Texas--I mean, New York----

Mr. **NADLER.** I am glad you remembered that one.

Judge **PAINE** [continuing]. Critically need these additional positions and it is unfair to the courts not to receive them as quickly as possible.

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Mr. **NADLER.** Thank you.

Mr. **BRYANT** [presiding]. The Chair will yield to the gentleman from Massachusetts for his time.

Mr. **MEEHAN.** Thank you, Mr. Chairman.

Mr. Tatelbaum, obviously one of the most important issues that we are going to confront is whether to establish a binding set of Federal exemptions under chapter 7. Currently, States establish their own rules as to what sort of property should be exempt from liquidation to discharge debt. It is said that some individuals accumulate assets in States with liberal exemptions precisely because they know that that much of the assets will be exempt from liquidation. Creating a binding set of Federal exemptions would likely stop this abuse in the bankruptcy system. But it also may overlook the fact that cost of living and lifestyle preferences often vary from State to State.

What are the tradeoffs involved in the creation of a uniform set of Federal exemptions? And, on balance, is this a desirable policy that we should be striving for?

Mr. **TATELBAUM.** If I might answer your last question first, I think yes. I think the more unified the bankruptcy system is, the fairer it is, and it stops the forum shopping, which clearly now exists.

The real problem with a uniform set of exemptions, as pointed out, besides lifestyle or a variation of that, is just geographic differences. For instance, one of the Commission's considerations now is to deal with retirement accounts and have them be exempt, unless they are loaded upright at the end. This is a very commendable idea, but for someone who is a farmer in South Dakota and does not have 401(k)'s and may not have an IRA and uses all of their free money to build up equity in their farm and you have a ceiling on exemptions from real estate, that may help someone who lives in a populous State but not help someone who lives in a farm State. I think the question is: How do you create the balance?

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I think if you create the balance, it is a very commendable thing, because someone has to voluntarily go into bankruptcy in most instances and they can choose it or not. If they don't like it, they can stay with their State exemptions.

Mr. **MEEHAN.** Thank you.

Judge Paine, Mr. Conyers earlier talked about the proposed changes of bankruptcy judges being converted from title I to title III in order to eliminate some of the tricky jurisdictional and constitutional questions that have long plagued the bankruptcy system.

I was wondering, number one, what do you think of that transfer and what do other judges think of it; and how should a transition from article 1 to article 3 judgeships be managed? In other words, would the current bankruptcy judges have to be confirmed in the Senate like article 3 judges or could they be grandfathered in as article 1 judges if they so desired?

I was wondering, two-part question, or if you don't really want to say, what do other judges think of it, and then assuming that we look at this, what should the transition process, how do you envision it?

Judge **PAINE.** In 1984, during the Marathon crisis, I supported an article III bankruptcy court because we knew article III worked and worked well. The experience has been in the past 12 to 13 years that the Bankruptcy Court has functioned under article I. My personal view is it is working now.

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Within our organization, we have some judges that support article III status, some that support article I status, and some that support article I status, if they can get it. About transition--I have heard academics talk about this, and as but a poor country bankruptcy judge, I don't know if I am qualified to speak on this--there can be a transition where the judges are grandfathered in with new appointments being article III and the article I judges remaining until their terms are out. It would have to be carefully crafted in order to protect the system. Particularly because you would give notice to every litigant at that point that there might be a problem, and this is an issue that they could raise as to jurisdiction.

Mr. **MEEHAN.** Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. **BRYANT.** Thank you.

I believe I am the last questioner today, and I wanted to just touch, if I could, on this issue that I think I raised earlier with the previous panel and get your opinions on interposing into the consumer bankruptcy system someone at some standard who would evaluate the cases and their feasibility and then have some sort of requirement that they would have to file, let's say, a chapter 13, rather than a chapter 7.

Mr. **TATELBAUM.** I think the concept is something that should be considered.

The problem, and it goes to Congressman Meehan's point as well, at least from my perception living in Florida and knowing the success in Tennessee of chapter 13's, a lot of problems between chapter 13 and chapter 7 are exemptions because there is no incentive in some States to go into chapter 13, irrespective of your income, because you can keep everything.

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If, while maintaining the judicial nature of the situation, because I believe--and this is my personal belief, that it has to be maintained within the judicial system, if there were a judicial method of doing that, that would be something to consider. Because what I believe has happened, even though there is an oath that has to be filed by the attorneys now, when the attorneys advertise like this, they do not tell the people about chapter 13. It is too expensive for them. It is too time consuming and chapter 7 is easier. If there was a process to weed that out, I think as Judge Paine said with chapter 12, people who work in the system may not even file the bankruptcy.

But now with the availability of chapter 7, consumer credit counseling has their hands up. Some of the very strong armed tactics of the creditors force it as well, and if there were a way to eliminate some of the polarization that now exists from various factors I think it is something that should be considered.

Judge **PAINE.** I come from a State where we do have predominantly chapter 13's. The system works very well in Tennessee. It works well because we have good debtors who want to repay their debt. We have superb creditors who understand the best deal they are going to get is in chapter 13 so they promote it. We have really good lawyers who try to do the best job for their clients. And we have judges who support it by going to speak to both debtor and creditor groups to preach the gospel of chapter 13. So it works where we come from, as you know from having practiced as a lawyer there.

I would be interested if a system could be set up that would make these really tough decisions in a consumer area. You get into parochial school costs, you get into tithes to churches, you get into children at home because they are home schooled and a one-income family. You have disabled or elderly parents now living with a debtor. How do you determine which expenses are appropriate to factor into the disposable income the debtor? I would be hard pressed to create the system that allowed that.

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Mr. **BRYANT.** Well, that will conclude my questioning, and again, I want to thank you, on behalf of the subcommittee, for your attendance today. You have added a great deal to our understanding. Thank you very much. This hearing is adjourned.

[Whereupon, at 12 p.m., the subcommittee adjourned.]

A P P E N D I X

Material Submitted for the Hearing

LETTER DATED APRIL 18, 1997, to Chairman Gekas, From Michael J. Ferrell, Senior Vice President, Mortgage Bankers Association of America,
MORTGAGE BANKERS ASSOCIATION OF AMERICA,
Washington, DC, April 18, 1997.

Hon. **GEORGE W. GEKAS,** *Chairman,*
Subcommittee on Commercial and Administrative Law,
Washington, DC.

DEAR MR. CHAIRMAN: The Mortgage Bankers Association of America (MBA) appreciates the opportunity to present our views with respect to the Subcommittee's hearing on Oversight on the Operations of the Bankruptcy

System and a Status Report from the National Bankruptcy Review Commission.

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MBA is the national association representing exclusively the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of over 2,900 companies includes all elements of real estate finance: mortgage companies; savings and loan associations; commercial banks; savings banks; life insurance companies; state housing finance agencies; and others in the mortgage lending field.

(1) *Clarify that home mortgages may not be modified.* Congress should clarify that the Bankruptcy Code is to be applied in a manner that recognizes the priority that Congress has attributed to widespread homeownership and the intricate system that finances homeownership. Congress has consistently, repeatedly and overtly said that homeownership is a national priority. So has the Executive Branch, and indeed increased homeownership is an emphasized goal of President Clinton. The United States Supreme Court recently recognized this national priority in its 1993 decision in *Nobelman* v. *American Savings Bank*, 508 U.S. 324.

But other courts apparently are not comfortable with this recognition, and continue to seek ways to thwart the Congressional priority of homeownership. The First Circuit, for example, has decided that the fact that two families other than the debtors' resided in the mortgaged property took away the protection afforded home mortgage holders in Chapter 13, notwithstanding that the National Housing Act defines one-to-four family housing mortgages as home mortgages, and that the court's own opinion reflects that "the mortgage is in the standard FNMA for singlefamily dwellings..." *Lomas Mortgage, Inc.* v. *Louis*, 82 F.3d 1 (1996). As an additional example, the Third Circuit has indicated that holders of home mortgages will not be protected in Chapter 13 if the mortgage includes coverage of fire insurance proceeds, real estate tax escrow funds, or fixtures, even though these are customarily part of and incidental to principal residences. See: *In re: Johns*, 37 F. 3d 1021, (1994).

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The purpose here is not to dispute the reasoning in these opinions. It is to point out that, as currently expressed, the Code would seem to provide room for decisions that are not sympathetic to the manner in which the home finance system, which Congress intended to specially encourage, actually works and has worked since before the latest expression of Congress, the 1994 Bankruptcy Amendments (P.L. 103—394).

To put such a recommendation in perspective, an explanation of why such protection makes sense might be appropriate. The explanation can be summed up in three characteristics of the modern, American home mortgage market: low down payments, efficient interest rates and constant supply.

Until Congress created the Federal Housing Administration (FHA) home loan mortgage insurance program, now operated by the Department of Housing and Urban Development, and the VA home loan guaranty program, operated by the Department of Veterans' Affairs, mortgages were only available in amounts up to 75 or 80 percent of the value of the home. With the use of FHA and VA programs, and conventional (that is, non-government) mortgage insurance programs patterned after the FHA and VA programs, mortgages up to 95 and 97 percent became common. Prospective homebuyers who are unable to, or have not yet accumulated a 20 or 25 percent down payment can nevertheless become homeowners.

What the mortgage insurance programs provide to the mortgage lender is a substitute for equity. If the borrower is not able to pay, the mortgage insurance program covers the loss of the lender. But each of these programs has a common characteristic. They require the lender to be able to liquidate the mortgage before they will pay a claim for loss. If a home mortgage insured or guaranteed under these programs is bifurcated and modified in a completed Chapter 13 plan, the lender is left with a loss, yet is unable to satisfy the condition of claiming reimbursement for the lender's loss. The FHA and the VA have each announced that their program will not honor claims for amounts forgiven by bankruptcy courts in cramdowns. They have said that if there is a foreclosure subsequent to the bankruptcy and cramdown, they will only pay a claim based on the crammed down amount, not the full amount of the mortgage.

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Almost all providers of home mortgage finance use the secondary market for mortgages. A significant aspect of the secondary market is the mortgage-backed security. These securities are based on and backed by pools of mortgages. The size of this efficient market is immense. At the end of 1995, $3.6 *trillion* in home mortgages were outstanding, of which $1.75 trillion, or approximately one-half, were in mortgage-backed securities. The secondary market, especially the mortgage-backed security portion of it, is part of the international capital markets. Using this highly efficient market, mortgage lenders make mortgage finance available to home buyers at rates lower than those available to major corporations. Access to the secondary markets is made possible by instrumentalities created by Congress: the Government National Mortgage Association, the Federal National Mortgage Association and the Federal Home Loan Mortgage Association (Ginnie Mae, Fannie Mae and Freddie Mac).

Prior to the creation of these secondary market instrumentalities, most mortgage lending was funded by local depository institutions, predominantly savings and loan associations. When a local economy turned downward, in those days, disintermediation would occur, that is, the local depositors would take their deposits out of the local bank, and the local bank would have no funds to make mortgage loans. With the operation of the international secondary mortgage market, funds are available all over America all the time.

A characteristic of mortgage-backed securities is that investors are promised they will receive both interest and principal, in full and in a timely manner, whether or not the interest and principal due on the underlying mortgages is received by the issuer of the security. In order for mortgage lenders to issue mortgage-backed securities, a predictable flow of principal and interest is essential. Delays and the threat of delays, and cramdowns and the threat of cramdowns in bankruptcy disrupt that predictability.

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(2) *Clarify that protracted delay is not a permitted basis for serial re-application of the automatic stay.* Congress should clarify that delay alone is not an adequate basis for allowing repeated stays. Currently, mortgage holders are experiencing repeated application of the automatic stay with regard to mortgaged property in a variety of ways: multiple filings by the same debtor, with early filings abandoned before dismissal or with filings dismissed; multiple and repetitive re-instatements of plans in a single case with no demonstrable good-faith reason for a second or third try at fulfilling a plan; or variations on these themes. While these experiences are shared by other creditors, the impact on the mortgage finance system is special because the foreclosure process, which is inherent to the success of the system, as explained above, must be stopped and restarted each time the automatic stay comes into play.

(3) *Eliminate unnecessary delay in receipt by mortgage holders of monthly payments.* Chapter 13 Trustees should be required to make interim disbursements of monthly mortgage payments in all cases which are not confirmed within a specific period of time, say, three months, and should be required to make the monthly payments on time, or pay late fees as provided in the mortgage.

(4) *Provide a mechanism for establishing more uniformity of legal interpretations and practices.* The variety of interpretations of the Code and of procedures from District to District and even from Judge to Judge adversely impacts a wide range of creditors. As noted above, the mortgage market is a national one so that mortgage bankers are aware of the variety, but this is an across the board problem.

Once again, MBA commends you and the Members of the Subcommittee for your efforts to review and update the Bankruptcy Code. MBA appreciates the opportunity to submit a statement in conjunction with your April 16 hearing.

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Please contact Jim Freeman at (202) 861—8184, if you have further questions or need additional information.

Sincerely,

MICHAEL J. FERRELL,
Senior Vice President.

41—947CC

1997

OPERATION OF THE BANKRUPTCY SYSTEM AND STATUS REPORT FROM THE NATIONAL BANKRUPTCY REVIEW COMMISSION

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE
COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

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FIRST SESSION

APRIL 16, 1997

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C O N T E N T S

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Williamson, Brady C., Chairman, National Bankruptcy Review Commission

LETTERS, STATEMENTS, ETC., SUBMITTED FOR THE HEARING

Case, Stephen H., Esq., Davis, Polk & Wardwell: Prepared statement

Gekas, Hon. George W., a Representative in Congress from the State of Pennsylvania, and chairman, Subcommittee on Commercial and Administrative Law: Opening statement

Jackson Lee, Hon. Sheila, a Representative in Congress from the State of Texas: Prepared statement

Paine, George C., II, Chief Judge, U.S. Bankruptcy Court, Middle District of Tennessee, on behalf of the National Conference of Bankruptcy Judges: Prepared statement

Rosen, Leonard M., Esq., Wachtell, Lipton, Rosen & Katz: Prepared statement

Tatelbaum, Charles, Esq., vice president for research, American Bankruptcy Institute: Prepared statement

Williamson, Brady C., Chairman, National Bankruptcy Review Commission: Prepared statement

APPENDIX

Material submitted for the hearing

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(Footnote 1 return)
Fox Meyer Health Corp., Anchor Glass Container, G. Heileman Brewing, Best Products Co., Anacomp, Inc., Morrison Knudsen Corp., Color Tile Inc., Discovery Zone, Inc., Tipbook Finance Corp., and Kenetech Windpower, Inc.

(Footnote 2 return)
Warren, *Business Bankruptcy,* Federal Judiciary Center, 1993.

(Footnote 3 return)
20 Stat. 54(1898); L. LoPuki, Strategies for Creditors in Bankruptcy Proceedings.

(Footnote 4 return)
Pub. L. No. 95—598, 92 Stat. 2549 (1978).

(Footnote 5 return)
52 Stat. 840 (1938).

(Footnote 6 return)
Pub. L. No. 103—394 (1994).

(Footnote 7 return)
To assist the Commission and Congress in the identification of issues in need of reform, the ABI is conducting the Bankruptcy Reform Study Project. The Project produced dozens of analytical papers and sponsored ten symposia on a wide range of hotly debated bankruptcy issues. In December, ABI released the results of a broad-based and comprehensive empirical survey of professionals involved in the bankruptcy system. The ABI's *Report on the State of the American Bankruptcy System* (attached) reflects the views of attorneys, accountants, academics, judges, trustees, lenders, credit managers, turnaround consultants and others, or topics such as abuse in the bankruptcy system, causes of bankruptcy, consumer bankruptcy, business reorganization, jurisdiction and procedural issues, and more.

(Footnote 8 return)
Other provisions related to court jurisdiction are found in Title 28, provisions relating to bankruptcy crimes are found in Title 18 and miscellaneous other related provisions are placed throughout the U.S. Code. Procedural rules are found in the *Federal Rules of Bankruptcy Procedure* and in Local Rules adopted by various bankruptcy courts.

(Footnote 9 return)
11 U.S.C. Section 362(d)(1).

(Footnote 10 return)
11 U.S.C. Section 362(d)(2).

(Footnote 11 return)
11 U.S.C. Section 363(c)(2).

(Footnote 12 return)
11 U.S.C. Section 363(c)(4).

(Footnote 13 return)
11 U.S.C. section 363(c)(3).

(Footnote 14 return)
Kane v. *Johns-Manville Corp.*, 68 B.R. 618 (Bankr. S.D.N.Y. 1986), *aff'd in part*, *rev'd in part*, 78 B.R. 407 (S.D.N.Y. 1987), aff'd, 843 F.2d 636 (2d Cir. 1988).

(Footnote 15 return)
Only individuals (as opposed to partnerships and corporations) are entitled to exemptions.

(Footnote 16 return)
In order to promote utilization of Chapter 13, Chapter 13 extends the discharge to a greater group of debts than does Chapters 7 and 11.

(Footnote 17 return)
For the purpose of this calculation, a husband and wife are deemed to be one individual.

(Footnote 18 return)
The survey was designed and conducted in accordance with generally accepted survey techniques and statistical principles by Dr. Louis H. Primavera, Ph.D., and Dr. Bernard S. Gorman, Ph.D., of the St. John's University Graduate School of Arm and Sciences. A detailed explanation of the survey methodology is contained in the report of Dr. Primavera and Dr. Goldman, titled "Methodology for the Membership Survey for the American Bankruptcy Institute." For the purposes of this Report, and following accepted statistical procedure, the probability level of less than or equal to .05 was selected as the test of significant association.

(Footnote 19 return)
Respondents devoting at least 50 percent of their practice to debtor representation, or trustee representation were defined as debtor representatives, creditor representatives, or trustee representatives, respectively. Respondents devoting at least 25 percent of their practice to the representation of official committees were defined as committee representatives.

(Footnote 20 return)
The ten largest cities were defined as the districts that included the ten largest U.S. cities by population based on the 1990 Census. Mixed districts were those including cities ranked 11th through 50th, unless the district was already included in the "ten largest" cohort. The remaining districts were defined as rural.

(Footnote 21 return)

Business Chapter 11 professionals were defined as those devoting at least 50 percent of their practice to business Chapter 11 cases. Those who also devoted least 50 percent of their practice to the representation of debtors or creditors were defined as business Chapter 11 debtor representatives or business Chapter 11 creditor representatives, respectively.

(Footnote 22 return)
As a proxy for this group, this cohort was defined to include respondents who both devoted at least 75 percent of their practice to business Chapter 11 cases and who listed their primary districts as either the Central District of California, the District of Delaware, the Northern District of Illinois, or the Southern District of New York.

(Footnote 23 return)
Those districts were the Southern District of California, the District of Delaware, the Northern District of Illinois, and the Southern District of New York.

(Footnote 24 return)
Out of Hook_Credit Card and Personal Debt (Dahlstrom & Company).

(Footnote 25 return)
Federal Reserve.

(Footnote 26 return)
Federal Reserve.

(Footnote 27 return)
New York Times, March 18, 1997.